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INTRODUCTION

In accordance with the City Auditor's 1991-92 Audit Workplan, we conducted an audit of the Redevelopment Agency of the City of San Jose. We conducted this audit in accordance with generally accepted government auditing standards and limited our work to those areas specified in the Scope and Methodology section of this report.

BACKGROUND

Upon determining that there was a need for redeveloping portions of the City, the San Jose City Council activated the Redevelopment Agency of the City of San Jose (Agency) in 1956. The mission of the Agency is

> *To implement the City's Redevelopment Plans for the downtown, industrial, and Neighborhood Business District project areas, through direction and coordination of all public/private redevelopment efforts; to implement and coordinate actions to further the City's economic development program. The impact of existing and future redevelopment extends far beyond construction activity. The paramount goal of redevelopment is improving the quality of life for the families and businesses which make up the San Jose community. As improved parks and transportation services, historic preservation projects, visitor attractions, inspirational cultural and entertainment events and new housing create a vibrant 24-hour city, new tax revenues generated by redevelopment supplement the General Fund and provide additional funds for services to residents city-wide.*

Since 1961, the Agency has designated 17 redevelopment project areas. Beginning in 1980, 15 redevelopment project areas have been merged for the purpose of allocating incremental property tax revenues. San Jose redevelopment areas now total nearly 7,400 acres, including two major industrial redevelopment areas encompassing 6,700 acres and nine downtown redevelopment areas encompassing 450 acres.

Tax Increment Financing

The California Community Redevelopment Law (Redevelopment Law) authorizes the use of local property taxes to finance redevelopment projects to promote the development of blighted areas.[1] Under Redevelopment Law, once an

[1] **Blight** - Either physical, social, or economic liabilities in a community requiring redevelopment in the interest of the health, safety, and general welfare of the people of such a community.

area is designated as a redevelopment area, the property taxes for that area are fixed or frozen. As long as that area continues to be a redevelopment area, the fixed amount of property taxes previously established will be distributed to Santa Clara County (County), the City of San Jose (City), school districts, and other authorities. However, all additional property taxes from the redevelopment area go to the Agency. These additional property taxes, called tax increments, result from the incremental assessed valuation of property in the redevelopment areas. These incremental assessed valuations result from annual 2 percent inflation increases allowed under Proposition 13 and from reassessments of existing property because of changes in ownership and new construction.

The County allocates property tax increments to the Agency annually. The Agency uses these taxes to fund new construction and improvements, to pay debt service on obligations issued to finance redevelopment projects, and to pay for its cost of operations. Redevelopment agencies in California are not subject to the spending limitations of the Gann Limit.

While City revenues may be used for the full range of City services, Agency funds, with limited exceptions, may be spent only in redevelopment areas and may not be used for public services such as police and fire protection. Agency-supported physical improvements are meant to increase property values and stimulate private investment in redevelopment areas. In addition, Redevelopment Law requires that the Agency allocate 20 percent of its tax increment revenues to support low- and moderate-income housing throughout the City.

When redevelopment is finished in a redevelopment project area (typically in 30 to 40 years) and all Agency debts are paid, the redevelopment effort is terminated. From that point on, all property tax revenues from that area go to the other taxing agencies within the project area in proportion to their respective tax rates.

Tax Allocation Bonds And COPS Financing

Redevelopment Law stipulates that the Agency can pledge future tax increment revenues to secure the issuance of tax allocation bonds. Since 1977, the Agency has issued over $720 million in bonds, of which $433 million are outstanding. In addition, in 1986 the City issued Certificates of Participation (COPS) for the purpose of financing the Convention Center. The distinguishing feature of the COPS is a lease-purchase agreement between the City and the Agency. Under the terms of the lease-purchase agreement, the City's General Fund makes an annual lease payment to the Agency for the Convention Center that is equal to the debt service payment for the COPS. The Agency subsequently reimburses the General Fund for its lease payment out of tax increments. Finally, during 1991-92, the Agency obtained two $18 million short-term loans.

Table I summarizes the total bonded indebtedness and other debt the Agency has incurred as of June 1992.

TABLE I

SUMMARY OF REDEVELOPMENT LONG-TERM DEBT
AS OF JUNE 1992

	Amount of Issue	Amount Outstanding
Bonded Indebtedness		
1977 Park Center	$ 9,650,000	$ 6,190,000
1977 Rincon	24,800,000	(1)
1983 Merged Area	93,000,000	(2)
1984 Merged Area	50,000,000	(2)
1985 Bonds	90,000,000	(2)
1986 Merged Area A and B	256,335,000	232,070,000
1989 Merged Area Series A	45,000,000	43,115,000
1991 Merged Area Series B	60,000,000	60,000,000
1992 Park Center	9,650,000	9,650,000
1992 Merged Area Series A	82,000,000	82,000,000
SUBTOTAL	$720,435,000	$433,025,000
Other Debt		
Certificates of Participation	174,175,000	172,735,000
1991 Commercial Paper	18,000,000	18,000,000
1992 Morgan Guaranty Loan	18,000,000	(3)
SUBTOTAL	210,175,000	190,735,000
TOTAL	$930,610,000	$623,760,000

LEGEND

(1) The Agency planned to use cash to defease the remaining Rincon bonds before delivery of 1992 Series A bonds.

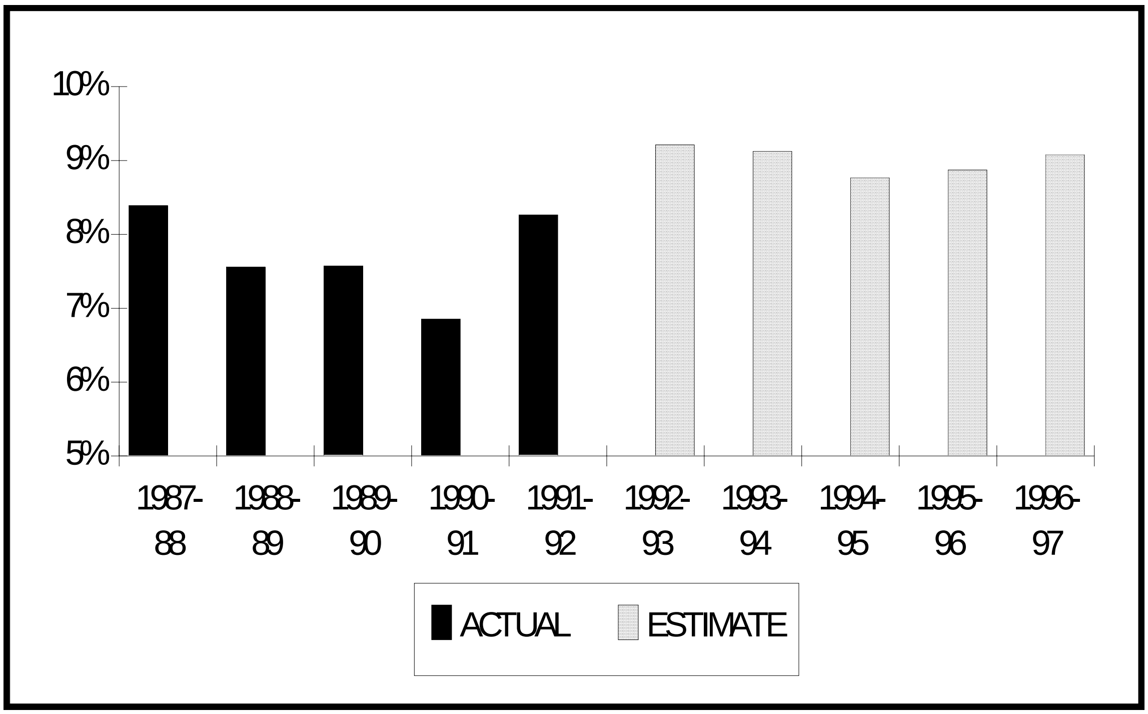
(2) Refunded by the 1986 Merged Area Series A and B bonds.

(3) The Agency planned to use proceeds of 1992 Series A bonds to repay this conventional loan.

The Agency's long-term debt as a percentage of the assessed valuation within redevelopment areas has remained between 6.85 percent and 8.39 percent from 1987-88 through 1991-92. In comparison, in 1989-90, the ratio of long-term debt to assessed valuation of the other nine largest redevelopment agencies in the state varied between 7.5 percent and 34.6 percent. Although the Agency's long-term debt increased 30 percent from 1987-88 through 1991-92, total assessed valuation of property within redevelopment areas increased by 31 percent. Using the Agency's estimates in its 1992-93 through 1996-97 five-year Capital Improvement Program (CIP), the ratio of debt to assessed valuation would increase to 9.2 percent (see Graph I).

GRAPH I

REDEVELOPMENT AGENCY'S LONG-TERM DEBT AS A PERCENT OF ASSESSED VALUATION IN REDEVELOPMENT AREAS



The 1986 Bond Indenture provides that the Agency may issue additional tax allocation bonds so long as tax revenues total at least 1.15 times the maximum annual debt service on the Merged Area tax allocation bonds then outstanding and on any additional bonds to be issued. Table II presents the Agency's debt service coverage ratio analysis for the 1992 Merged Area Series A bonds.

TABLE II

REDEVELOPMENT AGENCY'S DEBT SERVICE COVERAGE RATIO ANALYSIS FOR THE 1992 MERGED AREA SERIES A BONDS

1991-92 Total Gross Tax Allocations	$67,504,750
Plus anticipated supplemental revenue	1,547,279
Plus anticipated unitary revenue	1,523,593
Less 20% Housing Set-Aside	(14,115,124)
Less County Payment[1]	(1,709,223)
Tax Revenues Available for Debt Service	$54,751,275
Maximum Annual Debt Service	
1986 Bonds	$23,090,760
1989 Bonds	4,099,615
1991 Series B Bonds	5,443,206
1992 Series A Bonds	7,464,575
Total Parity Debt Service[2]	$40,098,156
Coverage Ratio	1.365 times

[1] The County Tax Sharing Agreement as amended August 30, 1988. The County Payment is subject to pending litigation (see "**BACKGROUND** - *Litigation*" for additional information).

[2] The 1977 Rincon bonds are to be defeased, thus the Rincon Requirement is not included in this analysis.

Source: 1992 Merged Area Series A Official Statement

It should be noted that the annual COPS debt service payment ($14,294,733 in 1991-92) is not included in the above analysis. This is because the COPS is not a tax allocation bond and therefore not subject to the 1.15 to 1 tax allocation bond debt service coverage requirement. Instead, COPS is subject to a debt service coverage requirement of 1 to 1, whereby revenues are defined as net tax increments plus interest income and operating expenses. Under the COPS, the City's General Fund would make any debt service payments necessitated by inadequate Agency tax increments.

Litigation

Several areas of litigation may affect the Agency's future revenue stream and, thus, its ability to issue additional long-term debt. First, the Agency has joined with other California redevelopment agencies to contest county fee collections for the cost of preparing and overseeing the property tax roll. The case is pending before the State Supreme Court. If the challenge is unsuccessful, the Agency will have to pay such fees to the County on an annual basis (approximately $900,000 in 1991-92).

Second, in 1991, the Santa Clara Unified School District (District) challenged the legality of the Agency's adoption of the Story Road, Alameda, and West San Carlos Street redevelopment plans and the merger of those plans into the Agency's Merged Area. The District claimed among other things that it was entitled to a 2 percent per year increase in its share of tax revenues. If the District prevails, the amount of such an increase will be determined by the courts.

Third, in July 1991, the County filed an action against the Agency and the City challenging the Agency's authority to issue Merged Area tax allocation bonds with maturities beyond the duration dates of the redevelopment plans. The Agency had planned to issue $80 million in bonds with maturities through the year 2021 (30-year maturities). Because of the County's action, the Agency was forced to issue $60 million in bonds with maturities through the year 2011 (20-year maturities). The Agency subsequently filed a cross-complaint against the County alleging a breach of contract and seeking damages arising from its inability to issue $80 million in bonds as originally planned. It is the Agency's position that because of the County's breach of contract, the annual County Payment[2] is no longer required ($1.7 million in 1991-92). The District and two other taxing entities then joined the County in its lawsuit against the Agency. On May 28, 1992, the Superior Court rejected the County's lawsuit; however, the County is expected to appeal the decision. Since the Agency's 1992-93 through 1996-97 CIP is based on bonding to capacity with 30-year maturities, losing the lawsuit would have had a profound impact on the Agency's bonding capacity. For example, we estimate that the Agency's bond proceeds could be reduced by approximately $149 million during the five years of the 1992-93 through 1996-97 CIP, if the Agency could not issue bonds that matured after the year 2011.

Capital Budget

The Agency's proposed 1992-93 Merged Area Capital Budget includes $64.7 million for capital projects in 1992-93, with a total of $326.8 million in capital projects over the course of the Agency's 1992-93 through 1996-97 five-year CIP. The Agency estimates its tax increments at $72.3 million for 1992-93, with a total of $420 million over the five years of the 1992-93 through 1996-97 CIP. Table III summarizes the Agency's source and use of funds in 1991-92, 1992-93, and 1992-93 through 1996-97.

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[2] In December 1983, the Agency, the County, and the City entered into a tax sharing agreement commonly known as the "County Payment." The agreement and its amendments were intended to provide for sharing tax revenues in South Rincon and to provide the County with a percentage of tax increments once the Agency's annual tax increment receipts from the Merged Project Area reached a certain level.

TABLE III

REDEVELOPMENT AGENCY MERGED
AREA SOURCE AND USE OF FUNDS SUMMARY (In Millions)

	Estimated 1991-92	Projected 1992-93	Projected 5-Year Total (1992-93 Through 1996-97)
Source of Funds			
Beginning Fund Balance	$ 41.6	$ 35.7	$ 35.7
Tax Increment	69.1	72.3	420.0
Supplemental Assessment	1.5	1.5	7.5
Bond Proceeds	137.8	94.5	329.4
Trust Account Interest	1.6	1.5	8.5
Redevelopment Fund Interest	4.6	9.0	26.0
Other/Miscellaneous	10.4	0.5	17.7
TOTAL	$266.6	$215.0	$844.8
Use of Funds			
Debt Service	$ 26.8	$ 39.2	$241.1
20% Housing	14.1	14.8	85.5
County Agreement Payment	1.7	1.8	10.4
COPS Lease Payments	14.3	14.9	77.3
SUBTOTAL (Obligated)	56.9	70.7	414.3
Capital Expenditures	157.9	64.7	326.8
Operating Expenditures	14.9	15.5	84.0
County Tax Collection Fees	0.9	1.0	5.4
Other Expenditures[3]	0.3	0.3	1.7
Capital Reserve	35.7	62.8	12.6
TOTAL	$266.6	$215.0	$844.8

Source: Proposed 1992-93 Capital Budget and 1993-97 Capital Improvement Program

Operating Budget

The Agency's proposed operating budget for 1992-93 is $15.2 million. Table IV summarizes the Agency's operating budgets.

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[3] Fiscal year 1992-93 does not reflect state budget cuts.

TABLE IV

SUMMARY OF REDEVELOPMENT AGENCY'S OPERATING BUDGETS
1989-90 THROUGH 1992-93 (In Millions)

Expenditures By Division	1989-90 Actual	1990-91 Actual	1991-92 Approved	1992-93 Proposed	Percentage Increase (Decrease) From 1989-90 Through 1992-93
Office of the Director	$1.9	$1.2	$1.6	$1.5	(21%)
Finance And Administration	2.5	2.0	2.6	2.6	4%
General Counsel	0.6	0.8	1.0	1.0	67%
Program Development	1.1	1.5	1.8	1.8	64%
Project Management	2.1	2.4	2.6	2.6	24%
Negotiations	0.0	1.0	1.2	1.2	--
Economic Development	0.6	0.0	0.0	0.0	--
SUBTOTAL	8.8	8.9	10.8	10.7	22%
Support Services/Overhead	1.5	3.2	3.6	3.6	140%
Mayor/Board	0.8	0.8	0.9	0.9	13%
TOTAL	$11.1	$12.9	$15.3	$15.2	37%

Source: Adopted 1991-92 Operating Budget and Proposed 1992-93 Operating Budget

As Table IV shows, operating expenditures have increased 37 percent since 1989-90.

The Agency pays the City for support services in various City departments. Support service positions are City departmental staff positions providing direct services to the Agency in return for Agency payment of salaries and other costs, including overhead charges. The Agency also funds 25 percent of the budgets of the Mayor and City Council for their role as the Redevelopment Agency Board.

Personal Services is the largest single item in the Agency's operating budget--51 percent in the proposed 1992-93 budget. Table V summarizes the Agency's operating expenses from 1989-90 through 1992-93.

TABLE V

REDEVELOPMENT AGENCY'S OPERATING BUDGET SUMMARY
1989-90 THROUGH 1992-93 (In Millions)

OPERATING BUDGET BY TYPE OF EXPENDITURE	1989-90 Actual	1990-91 Actual	1991-92 Approved	1992-93 Proposed	Percentage Increase (Decrease) From 1989-90 Through 1992-93
Personal Services	$5.3	$6.1	$7.5	$7.8	47%
Non-Personal Expenses	3.5	2.7	3.2	2.8	(20%)
Equipment	0.0	0.1	0.1	0.1	--
SUBTOTAL	8.8	8.9	10.8	10.7	22%
Support Services/Overhead	1.5	3.2	3.6	3.6	140%
Mayor/Board	0.8	0.8	0.9	0.9	13%
TOTAL	$11.1	$12.9	$15.3	$15.2	37%
APPROVED STAFFING					
Civil Service	25.0	27.0	23.0	22.0	(12%)
Non-Civil Service	70.0	83.0	95.5	96.5	38%
TOTAL	95.0	110.0	118.5	118.5	25%

Finance And Administration Division

The Agency's Finance and Administration Division provides fiscal and administrative coordination and management support for the Agency. The Division has 33 full-time equivalents (FTEs) and is responsible for preparing the Agency's five-year CIP and the annual capital and operating budgets and for performing revenue analyses and projections. The Division has also developed a budget model to determine the Agency's five-year bonding capacity. The Agency presents estimated revenues and the five-year capital budget resolution to the Board for approval. The annual budget is finalized through the passage of the annual appropriation resolution, which is the legal authority for enacting the budget.

Program Accomplishments

A part of our normal audit process is to request the management of the entity we are auditing to provide us with a memorandum summarizing any major program accomplishments. We include these accomplishments in our final audit report in order to fairly present the situation we find and to provide appropriate balance. Accordingly, on several occasions, the Office of the City Auditor requested the Agency to provide a listing of its significant accomplishments. However, the Agency declined to submit a separate memorandum of program accomplishments, citing instead its numerous publications.

SCOPE AND METHODOLOGY

Our audit focused on the Redevelopment Agency's (Agency) financial forecasting and reporting functions. We assessed the reliability of the Agency's revenue and bonding forecasts. In addition, we assessed the adequacy of the Agency's financial accountability to the Redevelopment Agency Board (Board). We reviewed the status of outstanding City Auditor recommendations for the Agency. We also reviewed Santa Clara County's (County) overall system for calculating the Agency's property tax increments. Finally, we assessed the adequacy of the Agency's procedures for contracts of $20,000 and under.

Our methodology included interviews with the Agency's Director of Finance and Administration, Assistant Director of Finance and Administration, Project Economist, Fiscal Officer, other Agency staff, and consultants. We also interviewed the staff in the Santa Clara County Assessor's Office and the City of San Jose Treasury Assistant. It should be noted that our review of the County's property tax collection and remitting system was limited to an overview of the system. We did not audit property tax collections or calculations.

The Agency has developed computer models for projecting tax increment revenues and bond proceeds and for preparing its capital budget forecasts. We reviewed the tax increment revenue forecasting model for completeness and accuracy. In addition, we reviewed the Agency's budget model to determine whether it appropriately estimates the timing and amount of future bond issues, debt service, obligated expenses, and operating expenses. We reviewed the source documentation for data that was entered into the 1991-92 models, verified the accuracy of mathematical formulas in the models, and assessed the appropriateness of the assumptions that drive the models. We interviewed Agency staff and consultants regarding their procedures for entering data into the computerized models and preparing the forecasts. The Agency was unable to provide us with previous years' revenue models. As such, we were unable to assess the effectiveness of previous forecasts and were limited to an analysis of the 1991-92 revenue forecast.

We reviewed the Agency's quarterly contract status reports of contracts of $20,000 and under to determine whether multiple contracts are being issued to one vendor during a fiscal year. It should be noted that we did not review contract files and thus cannot attest to compliance with the informal bidding procedure.

We also reviewed other Agency reports, including the annual Capital Budget and five-year Capital Improvement Program, Capital Cost Reports, and cash flow projections. We reviewed other documents, including the Agency's Administrative Procedures Manual, Trust Indenture, Official Statements, the Agreement for the Allocation of Tax Increment Funds Pursuant to Health and Safety Code Section 33401, the Certificates of Participation Reimbursement Agreement, and the California Community Redevelopment Law.

FINDING I

THE REDEVELOPMENT AGENCY CAN IMPROVE ITS FINANCIAL ACCOUNTABILITY

The San Jose Redevelopment Agency Board (Board) is mandated by California Community Redevelopment Law (Redevelopment Law) to approve the annual budget and amendments to the annual budget of the Redevelopment Agency (Agency). As such, the Board needs timely and sufficient financial information to adequately discharge its fiscal and policymaking responsibilities. However, our review of the financial information the Board regularly receives revealed that the Agency does not submit monthly financial information to the Board and has no written procedures for preparing interim financial reports. In addition, the Agency does not submit the Capital Cost Reports or cash flow projections it prepares internally to the Board, and the cash flow projections that the Agency prepares cover at most only a 12-month period. Finally, in our opinion, the memorandums the Agency presents to the Board for major budgetary or policy decision-making purposes lack adequate financial information. Specifically, we noted the following omissions in memorandums and other information the Agency presented to the Board:

- A November 27, 1990, memorandum and a February 4, 1991, Mid-year Capital Budget Review memorandum failed to identify that implicit in the Agency's budget model policy change was the refunding of $415 million in debt;

- A March 3, 1992, memorandum lacked sufficient financial information to allow the Board to make an informed decision regarding the approval of $82 million in additional bonds;

- The Agency's proposed 1992-93 through 1996-97 five-year Capital Improvement Program (CIP) failed to identify that implicit in the proposal was the concept of wrap-around tax allocation bond financing that could cost as much as $144 million in additional interest payments; and

– The Agency has not identified for the Board that, beginning in 1992-93, the Agency's current expenses will exceed current revenues.

As a result, the Board lacks the financial information needed to monitor the Agency's budget and assess its financial condition. The Agency can improve its financial accountability to the Board by (1) reporting directly to an established finance committee, (2) submitting monthly financial reports to the Board, (3) submitting quarterly Capital Cost Reports to the Board, (4) providing the Board with adequate financial information when requesting approval of bond issues or other financial considerations, and (5) demonstrating in its budget model that there are sufficient current revenues to pay for its current expenditures.

The Redevelopment Agency Board Is Mandated By Redevelopment Law To Approve The Annual Budget Of The Agency

Redevelopment Law mandates that the Board approve the Agency's annual budget and amendments to the annual budget. Therefore, to effectively discharge its responsibilities, the Board needs accurate, complete, and timely memorandums and interim financial reports. Without such financial information, the Board's ability to make sound policy and financial decisions regarding the Agency's annual budget and five-year CIP is impaired.

The Agency Has Not Submitted Monthly Financial Information To The Board Since July 1989

The Agency has not submitted monthly financial information to the Board since the City of San Jose (City) converted its automated accounting system to its

Financial Management System (FMS) in July 1989. Further, the Agency does not submit to the Board monthly reports comparing budget-to-actual and year-to-date tax increment revenues even though the Agency periodically monitors tax increment receipts against estimates and reviews documentation of Santa Clara County's (County) tax increment payments. The financial information the Agency does give to the Board includes the annual Capital Budget and five-year CIP, the Mid-year Capital Budget Review, the Agency section in the Monthly Investment Report, and the annual audited financial statements. The Agency also submits a Quarterly Status Report for Redevelopment Projects. Prior to the FMS conversion, the Agency submitted monthly Capital Cost Reports to the Board.

KPMG Peat Marwick, the Agency's external auditors, recommended in its 1990-91 management letter to the Agency that the Agency submit monthly financial reports to the Board to allow for better oversight and management of Agency activities. The Agency plans to develop monthly financial reports similar to those the City prepares for the City Council.

The City's Monthly Financial Report (MFR) includes these components:

- Status of key revenues and expenditures (adopted and revised budget, year-to-date expenditures and encumbrances, and comments);
- Description of trends in revenues and expenditures;
- Graphic comparison of current year's monthly cash balances with the prior year's levels;
- Graphic comparison of current year's year-to-date (YTD) revenues/expenditures by type against prior year's corresponding YTD revenues/expenditures;

– Schedule of source and use of funds (adopted budget, amendments, carryover encumbrances, revised budget, YTD actual, and prior YTD actual); and

– Graphic comparison of YTD revenues and expenditures by type by month.

Although the Agency believes it can produce the above information on an accurate and timely basis, it has not set a date to do so. Further, the Agency has not developed written procedures for the preparation of these proposed interim financial reports. Such procedures are necessary to ensure (1) consistent data entry, (2) adequate supervisory review, (3) management review and approval, (4) authorization of adjustments in accordance with established policies and procedures, and (5) appropriate distribution.

In our opinion, the Agency should target a date for preparing monthly financial reports in a form similar to the City's. Further, the Agency needs to develop written procedures for the preparation of these monthly reports. Once these monthly reports are available, the Agency should provide them to the Executive Director and the Board.

Finally, it should be noted that at its regular meetings, the Board is responsible for reviewing and approving numerous and complex financial agreements, memorandums, and other documents. Some municipal legislative bodies establish smaller finance committees whereby its members meet to review financial reports and fiscal issues in greater detail and present recommendations to the full legislative body. Similarly, the San Jose City Council has a Finance Committee that reviews in detail various financial reports and makes recommendations to the full City Council. This smaller committee setting tends to facilitate discussion and inquiry regarding the City's financial reports and ultimately results in a fuller understanding of the fiscal implications of various administration proposals. A Redevelopment Agency Board finance committee similar to the City Council's could increase the Board's understanding and awareness of the Agency's financial status and improve the Board's ability to make sound financial and policy decisions.

The Agency Does Not Submit The Capital Cost Reports Or Cash Flow Projections It Prepares Internally To The Board, And The Cash Flow Projections That The Agency Prepares Cover Only A 12-Month Period

Capital Cost Reports

The Agency's Capital Cost Reports include the following information on a project and a project area basis:

- Project name
- Appropriation number
- Fund information for funds held by City or Agency
    - Current year budget as adjusted during the year
    - Prior year encumbrances
- Project authorizations approved
- Year-to-date expenditures
- Year-to-date encumbrances
- Project authorization balance
- Remaining funds available

While the Agency is producing the above Capital Cost Reports for its own internal use, it is not providing these reports to the Board. FMS generates Capital Cost Reports for both the City and the Agency on a monthly basis. However, according to the Agency's Director of Finance and Administration, the Agency is not currently submitting Capital Cost Reports to the Board on a monthly basis because of FMS problems. For example, Agency staff identified 16 errors in the February 1992 FMS Capital Cost Report when they compared the information in the Capital Cost Report to the Appropriations Balance Report. It is the Agency's position that it will not submit the Capital Cost Reports to the Board until the FMS problems are corrected.

Currently, the Agency submits to the Board a Quarterly Status Report for Redevelopment Projects, which is a narrative description of the status of individual projects for the quarter. In our opinion, given the production problems a monthly Capital Cost Report seems to pose, the Agency should submit to the Board a detailed quarterly Capital Cost Report, together with the Quarterly Status Report for Redevelopment Projects, in order to provide the Board with the vital capital project information it is not currently receiving without imposing an undue burden on the Agency's staff.

Cash Flow Projections

At the beginning of each fiscal year, the Agency's Finance and Administration Division prepares a cash flow projection for a 12-month period. According to the Agency's Director of Finance and Administration, the cash flow projection is for investment and internal planning purposes. The Agency's Financial Projects Analyst periodically updates the cash flow projection with actuals and forecasted revisions for Agency Fiscal Officer and Director of Finance and Administration review and approval. According to the Agency's Director of Finance and Administration, the Agency submits the cash flow projection to the City's Treasury Division (Treasury) on a monthly basis. However, according to Treasury staff, the Agency provides Treasury with a cash flow projection only two or three times a year, and usually only when Treasury requests it.[4]

It should be noted that although the Agency is not regularly submitting cash flow projections to Treasury for investment planning purposes, the Agency's Senior Financial Analyst does call Treasury once or twice a week to advise it of upcoming significant cash disbursements. While these calls are helpful, they do not eliminate the need for formal cash flow projections that can facilitate Treasury's maximizing the City's and the Agency's pooled cash investment income. Accordingly, in our opinion, the Agency should submit formal cash flow projections on a monthly basis to Treasury as the Agency's informal procedures require.

Multi-year Cash Flow Projections

The Agency's annual cash flow projection is a consolidated report for both the Merged Area and Park Center project areas. It consists of a summary page of projected and actual cash receipts and cash payments and a detailed report for the individual project and total expenditures by project area. The Agency also prepares a rolling 12-month payment schedule for its major projects. However, the rolling 12-month payment schedule does not show payments required for multi-year projects past the rolling 12-month span. For example, the Agency's 1992-93

[4] It should be noted that since May 1992, the Agency has been providing cash flow projections to Treasury approximately every other month or when Treasury requests it.

annual cash flow projection showed $85 million in capital project expenditures for the Merged Area and Park Center project areas. Comparatively, the adopted Capital Budget for 1992-93 shows capital project expenditures of $134 million. Thus, $49 million in forecasted expenditures (which may or may not be encumbered) did not appear on the cash flow projection. A multi-year cash flow projection should account for most of the difference.

Unencumbered Cash Balance

According to the Agency's Director of Finance and Administration, before the Agency encumbers funds,[5] the Agency's Fiscal Officer verifies that there are sufficient unencumbered cash balances to completely cover the proposed expenditure. Also according to the Agency, when a contract is executed, the Agency encumbers the entire amount of the contract even in the case of multi-year contracts. Furthermore, according to the Agency, it always retains sufficient funds on hand to cover all encumbrances. In other words, the Agency treats encumbered funds as committed and not available for other purposes.

As a result of this policy, the projected available unencumbered cash balance is very important for the Agency's planning purposes. This is because the Fiscal Officer will approve contracts only if unencumbered cash is available. However, the Agency's projected unencumbered cash balance does not appear on its management reports. In our opinion, the Agency should (1) document its policy and clarify its procedures regarding encumbering funds for committed expenditures and (2) modify its cash flow projection to reflect available

[5] **Encumbrance** - An anticipated expenditure, evidenced by a contract or purchase order or determined by administrative action.

unencumbered cash balances on a monthly basis. Specifically, the Agency should report to the Executive Director and the Board on a monthly basis, the encumbrance balance, projected new encumbrances, liquidated encumbrances, and unencumbered cash balance. By so doing, the Agency would provide the Executive Director and the Board with additional and necessary information regarding future cash requirements and commitments.

Cash Flow Information To The Executive Director And The Board

Finally, we noted during our audit that the Agency's Finance and Administration Division does not submit copies of the Agency's cash flow projections to either the Agency's Executive Director or the Board. Furthermore, the Division does not plan to include cash flow information in the monthly financial report it is developing for the Board. According to the Division, such cash flow information would be useful to the Board only if it chose to micro-manage the Agency. However, in our opinion, monthly Agency cash flow projections would provide the Director and the Board with information that could be critical for policy and financial decision-making purposes because of the manner in which the Agency receives its tax increments and bond proceeds. Specifically, the County transmits tax increment and supplemental assessment revenues to the Agency. However, the Agency is obligated to transfer 80 percent of those funds directly to its Fiscal Agent for debt service and the remaining 20 percent to the City's Housing Department. The Agency does not receive its portion of tax increment or supplemental assessment revenues until the end of the fiscal year. At that time, the Fiscal Agent transfers tax increments and supplemental assessment revenues, net of debt service payments, back to the Agency.

Table VI summarizes the Agency's anticipated source and use of funds in 1992-93.

TABLE VI

SUMMARY OF REDEVELOPMENT AGENCY ANTICIPATED
SOURCE AND USE OF FUNDS FOR 1992-93

Beginning Cash Balance	$140,638,000
Source of Funds	
Net bond proceeds	$102,942,779
Net tax increments*	16,413,478
Interest	9,456,418
Other Revenue	2,883,615
Estimated cash receipts	$131,696,290
Use of Funds	
Capital projects	$84,601,000
COPS payment	14,870,333
Operating expenses	15,834,031
County Payment**	1,672,291
Estimated cash payments	$116,977,655
Ending cash balance	$155,356,635

* Tax increments and supplemental assessments net of debt service, 20% housing, and fiscal agent, letter of credit, and County tax collection fees.

** The County Payment is subject to pending litigation (See "**BACKGROUND -** *Litigation*" for further information).

SOURCE: 1992-93 Capital Budget and 1993-97 Capital Improvement Program and Redevelopment Agency Cash Flow Projection (July 2, 1992)

As shown in Table VI, the Agency estimates that it will have sufficient resources to cover proposed expenditures in 1992-93. However, it should be noted that the timing of the Agency's cash receipts and cash disbursements can be problematic. For example, while the Agency can expect to receive interest earnings throughout the year, it will not receive its $16 million share of net tax increments and supplemental assessments until June 1993. In addition, bond sale proceeds are expected in two lump sums--$27 million in November 1992 and $76 million in June 1993. Thus, the Agency will not receive $92 million of its anticipated $132 million in 1992-93 funding until June of 1993--the last month of the fiscal year.

Because of the Agency's large cash balance at the beginning of 1992-93, the Agency expects to be able to meet its cash expenditure requirements even if for some reason it could not issue bonds as anticipated. However, the Agency may not always have this luxury. For example, in the third and fifth years of the proposed 1992-93 through 1996-97 CIP, the Agency estimates its beginning fund balances at $3 million to $4 million. Thus, in the later years of the five-year CIP, if the Agency found itself unable to issue bonds on schedule, the Agency could have trouble funding its operations as well as its capital projects.

The Agency's Finance and Administration Division is responsible for preparing and monitoring the Agency's cash flow projections. Because of the timing of the Agency's cash flow, it is important that the Board be familiar with the Agency's projected cash flow position when making bonding and capital project decisions. Therefore, the Agency should provide the Board with multi-year cash flow projections on a monthly basis.

The Memorandums The Agency Presents To The Board For Major Budgetary Or Policymaking Purposes Lack Adequate Financial Information

The Agency submits numerous memorandums to the Board to support proposed major budgetary or policymaking decisions. Our review revealed that these memorandums frequently lacked sufficient financial information to serve as the basis for such decisions. Specifically, we noted the following omissions in memorandums and other information the Agency presented to the Board:

- A November 27, 1990, memorandum and a February 4, 1991, Mid-year Capital Budget Review memorandum failed to identify that implicit in the Agency's budget model policy change was the refunding of $415 million in debt;

- A March 3, 1992, memorandum lacked sufficient financial information to allow the Board to make an informed decision regarding the approval of $82 million in additional bonds;

- The Agency's proposed 1992-93 through 1996-97 five-year CIP failed to identify that implicit in the proposal was the concept of wrap-around tax allocation bond financing that could cost as much as $144 million in additional interest payments; and

- The Agency has not identified for the Board that beginning in 1992-93, the Agency's current expenses will exceed current revenues.

A November 27, 1990 Memorandum And A February 4, 1991 Mid-Year Capital Budget Review Memorandum Failed To Identify That Implicit In The Agency's Budget Model Policy Change Was The Refunding Of $415 Million In Debt

In December 1983, the Agency, the County, and the City entered into a tax sharing agreement commonly known as the "County Payment." The agreement and its amendments were intended to provide for sharing tax revenues in South Rincon and to provide the County with a percentage of tax increments once the Agency's annual tax increment receipts from the Merged Project Area reached a certain level.

In December 1990, Agency staff recommended, and the Board approved, a change in the handling of the County Payment in the budget model to increase the Agency's bonding capacity. The Agency estimated that this adjustment to the model would allow the Agency to issue an additional $17 million in bonds.

The significance of the Agency-requested change in the handling of the County Payment lies in the fact that the 1986 Bond Indenture states that the County Payment should be excluded from tax revenues available for debt service. In our opinion, the Agency should have clearly identified to the Board that the proposed change in the handling of the County Payment was predicated upon the Agency refunding the 1986 Series A and B tax allocation bonds and the Certificates of Participation for the Convention Center (COPS). Even though the proposed refunding would involve $415 million in debt, the Agency failed to mention it in either its November 27, 1990, memorandum or in its February 4, 1991, Mid-year Capital Budget Review memorandum. Such an omission in the Mid-year Capital Budget Review memorandum is particularly significant because on December 12, 1990, the Board requested the Agency to return in 1991 with a full analysis of the impacts of all of the financing changes described in the Agency's November 27, 1990, memorandum. Most certainly, the Agency should have included in any subsequent analysis of financing changes a proposed refunding of $415 million in debt.[6]

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[6] The County Payment became subject to pending litigation in July 1991--after these events took place (See "**BACKGROUND -** *Litigation*" for further explanation).

A March 3, 1992 Memorandum Lacked Sufficient Financial Information To Allow The Board To Make An Informed Decision Regarding The Approval <u>Of $82 Million In Additional Bonds</u>

On March 19, 1992, the Agency presented a March 3, 1992, memorandum to the Board that in our opinion did not have enough financial information to allow the Board to make an informed decision regarding a requested bond issue not to exceed $82 million. Specifically, the Agency's memorandum excluded information such as (1) what effect the new bonds would have on the Agency's debt service coverage ratios, (2) estimated 1991-92 certified revenues, and (3) when receipt of funds was anticipated.

In addition, the Agency's March 3, 1992, memorandum identified only $23.9 million in proposed uses for the up to $82 million in requested bonds. Further, the memorandum incorrectly identified how $5.9 million in bond proceeds were proposed to be used. According to the Agency's memorandum to the Board,

> *Bond proceeds will be used to repay an $18 million short term credit agreement with Morgan Guaranty as anticipated in the credit agreement. Additionally, bond proceeds will retire the remaining $5.9 million Rincon de los Esteros Redevelopment Project 1977 Bonds.*

However, according to the April 1, 1992, official statement for the $82 million bond issue, none of the bond proceeds were to be used to retire the $5.9 million Rincon de los Esteros 1977 bonds. Specifically, the official statement states in part

> *The Agency is issuing the 1992 Series A Bonds to finance various redevelopment projects within the Merged Area and to refinance an $18 million loan from Morgan Guaranty Trust Company of New York (the proceeds of which were used to finance tax-exempt redevelopment projects within the Merged Area). . . <u>The Agency intends to defease the 1977 Rincon Bonds prior to delivery of the 1992 Series A Bonds</u>.* (Emphasis added)

According to Agency staff, documents such as the March 3, 1992, memorandum to the Board are preceded by years of official statements and reports that include vast amounts of financial information. The Agency's Director of Finance and Administration also stated that the Board did not need detailed financial information at that time because the Board is well aware of bond counsel, financial advisor, underwriter, and credit rating agency involvement before bonds are issued or other financial decisions are made. While the Agency's Director of Finance and Administration is technically correct, in our opinion, the Board should not have to rely on its institutional memory or entirely on outside entities when making major financial decisions that could affect the City and the Agency for 30 years or more. Given the level of responsibility the Board assumes when making such decisions, sufficient and adequate financial information is both appropriate and necessary.

The Agency's Proposed 1992-93 Through 1996-97 Five-Year CIP Failed To Identify That Implicit In The Proposal Was The Concept Of Wrap-Around Tax Allocation Bond Financing That Could Cost As Much As $144 Million In Additional Interest Payments

The Agency's proposed 1992-93 through 1996-97 CIP assumes the issuance of $289 million in new wrap-around tax allocation bonds. Our review revealed that the information supporting the Agency's proposed 1992-93 through 1996-97 CIP failed to identify to the Board that

– The $289 million in new tax allocation bonds were assumed to be a type of debt structure the Agency had not used before called wrap-around tax allocation bonds; and

– The use of these wrap-around tax allocation bonds could cost the Agency as much as $144 million in additional interest payments when compared to the 30-year level debt service bonds the Agency traditionally issues.

The proposed 1992-93 through 1996-97 CIP the Agency submitted to the Board on April 1, 1992, included the issuance of $289 million in new wrap-around tax allocation bonds as follows:

Fiscal Year New Bonds Are To Be Issued	**Principal Amount of New Wrap-Around Tax Allocation Bonds**
1992-93	$ 31,644,765
1993-94	54,494,240
1994-95	65,300,669
1995-96	70,713,038
1996-97	66,513,889
Total	$288,666,601

Our review of the information the Agency submitted to the Board to support the Agency's proposed 1992-93 through 1996-97 CIP revealed that the Agency did not identify that the $289 million in new bonds shown above were assumed to be a different type of debt structure known as wrap-around tax allocation bonds.

The concept of wrap-around financing involves the borrower making interest-only payments for a predetermined time period (the interest-only period), after which the borrower makes both principal and interest payments for another predetermined time period (the amortization period). Because initial debt service payments do not include any amortization of principal, the borrower pays less during the interest-only period than for an equivalent conventional loan. Conversely, because the principal amortization period is shorter for wrap-around tax allocation bonds, the borrower pays more during the amortization period. Furthermore, wrap-around tax allocation bonds carry a higher coupon rate than level debt service bonds. Agency staff estimated the difference would be 20 basis points (0.2 percent). For example, Agency staff estimated that the coupon rate for wrap-around financing in 1992-93 would be 6.8 percent versus 6.6 percent for level debt service bonds.

Implicit in the Agency's 1992-93 through 1996-97 CIP is a 16-year commitment, beginning in the year 2012, of the tax increments that are currently committed to paying the debt service on the 1991 Series B and 1992 Series A bond issues. These bonds mature in the year 2011, and the Agency intends to use the tax increments that become available after the year 2011 to pay for the amortization of the wrap-around tax allocation bonds during the 2012 through 2027 time period. For example, the proposed 1992-93 through 1996-97 CIP includes $54 million in wrap-around tax allocation bonds to be issued in 1993-94 with 17 years of interest-only payments (approximately $3.8 million per year until the year 2011) and 13 years of amortized principal and interest payments (approximately $6.5 million per year). The Agency would pay for the increased payments after the year 2011 from the $12 million in tax increments currently committed to the debt service for the 1991 Series B and 1992 Series A bonds which mature in the year 2011.

Historically, the Agency has issued tax allocation bonds and Certificates of Participation to finance capital projects. However, the concept of wrap-around financing is a marked departure from the Agency's more traditional debt financing philosophies. In our opinion, the Agency should have clearly identified such a philosophical departure to the Board during its review of the proposed 1992-93 through 1996-97 CIP to facilitate a full Board discussion, understanding, and ultimate imprimatur of the wrap-around financing concept.

We estimate that by issuing wrap-around tax allocation bonds instead of conventional 30-year bonds the Agency can issue an additional $32 million in bonds during the five years of the 1992-93 through 1996-97 CIP. However, it should be noted that the total interest payments for wrap-around financing will be substantially higher than for conventional financing. We estimate from the factors the Agency used in its budget model that the interest payments for the $289 million in 30-year wrap-around tax allocation bonds the Agency proposes to issue will total $504 million. Alternatively, we estimate that the total interest payments for more traditional 30-year conventional bonds would be $360 million. Thus, while wrap-around financing does give the Agency the ability to borrow an estimated additional $32 million during the 1992-93 through 1996-97 five-year period, it will cost the Agency an estimated additional $144 million more in total interest payments through the year 2027.

Alternatively, according to Agency staff, a present value analysis of the incremental cost of wrap-around financing is appropriate because it reflects the time value of money. Present value analysis expresses the value of a future stream of revenues or expenditures in current dollars. In the Agency's analysis, the present value difference between wrap-around and level debt service financing for the first 18 years is zero because the annual payments on both types of financing are the same. Once amortization begins in the year 2012, the present value of the increased payments on wrap-around tax allocation bonds is deeply discounted. The Agency estimates the present value of the additional principal and interest payments due on wrap-around financing at $33 million. Thus, according to Agency staff, "*The Agency has provided the Board the most cost-effective, risk free financing method.*"

However, a cost-benefit analysis yields a different conclusion. For example, net present value is the present value of the benefits minus the present value of the cost of those benefits. In this case,

$32 million in present value benefits (the additional funds that can be raised)
minus $33 million in present value costs (the additional principal and interest payments required)
-$1 million in net present value

The decision rule for net present value analysis is to recommend that an investment be made if the net present value is positive or zero. If the net present value is negative, it will cost more to raise the funds than they are worth.

In addition, Agency staff compared the costs of refunding the recent bond issues with maturities of less than 30 years in order to extend their maturities. Agency staff estimated redemption costs of 2 percent and reissuance costs at 3.5 percent of face value compared to 3.5 percent issuance costs for new wrap-around tax allocation bonds.

Finally, although using 30-year wrap-around tax allocation bond financing provides the Agency with additional leverage, the total cost may or may not outweigh the benefits. As such, the Board should be in a position to address the issue of wrap-around tax allocation bond financing costs versus benefits. This would allow the Board to assess the value of capital improvements funded with bond proceeds today versus the increased interest payments in the future. For example, if the Board chose to postpone $32 million in capital projects during the 1992-93 through 1996-97 CIP period, the Agency could save an estimated $144 million in interest payments. When the City Auditor and the Agency discussed the issue of additional interest payments, the Agency responded that its "*mission is to construct economic development projects, not to save money by removing such projects. . . This* [analysis] *suggests that the Agency is in business to save its money rather than invest in the community.*" The Agency's comment notwithstanding, in our opinion, without adequate and complete information regarding any implicit financing schemes, such as wrap-around financing, in the

Agency's proposed CIP, the Board cannot effectively exercise its policy and fiscal decision-making ability.

The Agency Has Not Identified
For The Board That Beginning In 1992-93
The Agency's Current Expenses Will Exceed Current Revenues

Our review revealed that, beginning in 1992-93, the Agency's total annual expenditures net of capital projects will exceed projected annual revenues net of bond proceeds. As shown in Table VII, the Agency's current revenues exceeded current expenditures in 1991-92. However, because the Agency bonded to capacity[7] in 1991-92, causing a significant increase in debt service, the Agency's current expenditures are projected to exceed its current revenues in 1992-93. Furthermore, because the Agency plans to continue bonding to capacity, this same situation holds true through 1996-97.

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[7] **Bond to Capacity** - Issuing the maximum allowable amount of bonds based on the Agency's certified revenues subject to the Tax Allocation Bond Debt Service Coverage of requirement 1.15 to 1 and COPS debt service coverage requirement of 1 to 1.

TABLE VII

REDEVELOPMENT AGENCY MERGED AREA
NET REVENUES (In Millions)

	Actual					Estimated					
	1986-87	**1987-88**	**1988-89**	**1989-90**	**1990-91**	**1991-92**	**1992-93**	**1993-94**	**1994-95**	**1995-96**	**1996-97**
CURRENT REVENUE (EXCLUDING BOND PROCEEDS)											
Tax Increment	47.3	49.0	57.0	62.3	64.3	69.2	72.5	77.1	83.8	88.4	95.0
Supplemental Assessments/ Subvention	4.0	4.9	5.3	7.8	4.0	1.5	1.5	1.5	1.5	1.5	1.5
Trust Account Interest	6.5	5.4	5.3	4.5	2.1	1.6	1.2	1.2	1.4	1.5	1.6
Redevelopment Fund Interest	14.9	12.5	10.0	8.6	6.4	4.6	8.0	5.2	3.2	2.1	2.5
Other/Miscellaneous	5.8	0.9	1.7	1.6	6.0	10.4	0.6	1.9	1.6	2.2	6.7
Total Current Revenue	78.5	72.7	79.3	84.8	82.8	87.3	83.8	86.9	91.5	95.7	107.3
CURRENT EXPENSES (EXCLUDING CAPITAL PROJECTS)											
20% Housing	9.5	9.9	11.7	14.3	14.0	14.1	14.8	15.7	17.1	18.0	19.3
Rincon Requirement	2.6	2.6	2.6	2.0	2.8	0.0	0.0	0.0	0.0	0.0	0.0
Debt Service	24.0	22.9	22.9	23.9	26.8	26.8	41.8	44.0	47.4	52.5	55.9
COPS Lease Payments	0.0	14.9	13.2	13.2	13.6	14.3	14.9	15.2	15.5	15.7	16.0
County Agreement Payment	0.0	0.0	1.5	1.5	1.6	1.7	1.7	1.8	1.9	2.0	2.2
Operating Expenses	7.4	9.1	10.1	10.7	13.3	14.9	15.8	16.1	16.8	17.4	18.1
Fiscal Agent/Letters of Credit	0.0	0.0	0.0	0.0	0.1	0.3	0.3	0.3	0.3	0.3	0.4
County Tax Collection Fees	0.0	0.0	0.0	0.0	0.9	0.9	1.0	1.0	1.1	1.1	1.2
Total Current Expenses	43.5	59.4	62.0	65.6	73.1	73.0	90.3	94.1	100.1	107.0	113.1
NET	**35.0**	**13.3**	**17.3**	**19.2**	**9.7**	**14.3**	**(6.5)**	**(7.2)**	**(8.6)**	**(11.3)**	**(5.8)**

Declines in several Agency revenue sources have contributed to the situation shown in Table VII. First, state subvention income has been eliminated. Second, trust account interest is expected to decline by 82 percent from 1986-87 through 1992-93 because the Agency replaced its required reserves with letters of credit and because interest rates have declined. Third, Redevelopment Fund interest declined steadily from 1986-87 through 1990-91 and is estimated to decline again in 1991-92. As a result, even though tax increment revenues are expected to increase by 53 percent from 1986-1987 to 1992-93, total Agency current revenues are expected to increase by only 7 percent during the same period. Furthermore, annual Agency expenses are up. Specifically, debt service including COPS lease payments and operating expenses are expected to increase by 136 percent and 114 percent, respectively, during the same period that total Agency revenues are expected to increase by only 7 percent.

As long as the Agency has sufficient carryover funds and/or continues to issue bonds, the Agency will have sufficient funds to finance the operating deficits shown in Table VII. However, a February 1991 Redevelopment Agency Mid-year Capital Budget Review included a review of the Agency's debt management strategy from municipal financial advisors Stone & Youngberg. While the advisors noted the Agency's sound financial condition due to its size and diversity and to the overall economic conditions of the Merged Area, they also warned the Agency and Board against using bond proceeds to pay for annual operating costs. Specifically, the review noted that

> *One very important strategic consequence of an analysis of bonding capacity is to make sure that the annual surplus is sufficient to cover the agency's annual operating expenditures. Each agency's needs will be different.* ***The point to stress is that annual operations should be financed out of annual revenues and not out of bond proceeds*** *so that operations would not be jeopardized if new bonds were not issued or if revenue growth slowed... Keep in mind that so long as the Agency's operating budget can be met from the annual surplus revenues, Agency operations are covered. Therefore,* ***it is most important that the Agency determine that the coverage factor plus other sources of recurring revenue for the CIP provide enough additional cash to the Agency to meet on-going operations****.* (Emphasis added).

It should be noted that, so long as the Agency has sufficient fund balances, its current operations will not be jeopardized. For example, although 1992-93 shows a projected Merged Area operating deficit of $6.5 million, the projected beginning fund balance of $36 million is more than sufficient to cover it. This is likewise true for the other years in the five-year CIP. However, in some years the Agency's cushion will be thin. For example, the CIP projected beginning fund balances in 1994-95, 1995-96, and 1996-97 are $9 million, $11 million, and $4 million, respectively. Furthermore, the Agency's forecast of unleveraged funds balance[8] (which includes carryover balances and advances and repayments of advances for capital projects) for the same years are only $8 million, $1 million, and $2 million, respectively.

In all fairness, it is important to note that in the future the Agency can also fund its current expenses by delaying capital projects. It should also be noted that the Agency's current annual revenues do not necessarily have to be sufficient to pay for current annual expenses. For example, the City Charter requires only that

> *The total of proposed expenditures shall not exceed the total of estimated income, estimated unencumbered balances of funds to be carried over from the preceding year and unencumbered available reserves.*

However, in our opinion, the Agency should demonstrate in its budget model that there are sufficient current revenues to pay for its current expenditures. Furthermore, the Agency could address any projected operating deficits by (1) reducing its annual operating expenses, (2) charging project-related operating costs to capital projects that can be funded out of bond proceeds, (3) requesting reduction of the City's reimbursement requirement, which currently stands at $4.5 million per year, or (4) restricting future debt service payments by not bonding to the current bonding capacities of 1.15 to 1 for tax allocation bonds and 1 to 1 for COPS.

Finally, while a case could be made that the Agency's entire operating budget is a capital expense and therefore subject to debt financing, such an approach conflicts with the following statement in *A Demonstration of Municipal Financial Analysis*:

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[8] The Agency defines unleveraged funds balance as that portion of cash which is not bond proceeds.

Using debt for operating purposes unfairly shifts the obligation for current services to future taxpayers. When capital funds are utilized, it should be assured that the benefits will be enjoyed by future taxpayers. If not, then the present taxpayers should pay for the services - and operating funds should be used.

CONCLUSION

The Agency can improve its financial accountability through better methods of financial reporting. The Agency discontinued submitting a monthly Capital Cost Report to the Board in July 1989 because of problems with FMS. In response to a recommendation from the Agency's external auditors, the Agency plans to submit a monthly financial report similar in format to that of the City. However, the Agency needs to document its procedures for preparing such interim financial reports. The Agency's monthly financial reports should also include multi-year cash flow and tax increment receipt information. The Agency should also report to an established finance committee, which would review the Agency's monthly financial reports and make recommendations to the full Board. Finally, the Agency's memorandums to the Board regarding major financial or policy decisions should include all relevant financial information.

RECOMMENDATIONS

We recommend that the Redevelopment Agency Board:

Recommendation #1:

Establish a finance committee to review the Agency's financial reports and make recommendations to the full Board. (Priority 3)

In addition, we recommend that the Redevelopment Agency:

Recommendation #2:

Submit monthly financial reports to the Executive Director and the Redevelopment Agency Board and develop written procedures for the preparation of the reports. The reports should include

– A year-to-date source and use of funds statement including capital expenditures by project area and revenues by type;

– A cash flow projection for the current fiscal year updated monthly with actuals and forecasted revisions, including unencumbered cash balances; and

– A multi-year cash flow projection showing major contract cash requirements. (Priority 3)

Recommendation #3:

Submit Capital Cost Reports along with the Quarterly Status Reports for Redevelopment Projects on a quarterly basis. (Priority 3)

Recommendation #4:

Submit cash flow projections on a monthly basis to the City of San Jose's Treasury Division. (Priority 2)

Recommendation #5:

Include all relevant financial information in memorandums to the Board when requesting approval for bond issues or other financial considerations. Such information should include projected debt service coverage ratios, certified revenues, pertinent cash flow information, and anticipated receipt of funds. (Priority 3)

Recommendation #6:

Demonstrate in its budget model that there are sufficient current revenues to pay for its current expenditures. (Priority 2)

FINDING II

THE REDEVELOPMENT AGENCY CAN IMPROVE THE RELIABILITY OF ITS REVENUE FORECASTING MODEL

The Redevelopment Agency (Agency) annually prepares a five-year projection of revenues. The Agency's five-year revenue projections are important because they are the basis for two major types of Redevelopment Agency Board (Board) planning decisions--bond financing and capital projects. As with all revenue projection models, the reliability of the Agency's model is a function of the basic econometric assumptions built into the model and the methodology the Agency uses to convert those assumptions into projected revenues. As part of our audit of the Agency, we analyzed and evaluated the five computerized spreadsheets the Agency uses to forecast revenues. Our analysis and evaluation revealed the following:

- The Agency's computerized spreadsheets do not sufficiently document the Agency's revenue projection methodologies or computations;
- The Agency does not keep adequate records to assess the validity of the econometric assumptions used in previous revenue projections;
- The Agency does not keep adequate records to assess the reliability of the assessed values of land, personal property, improvements, utility land, and exemptions used in its revenue forecasting model;
- The Agency incorrectly assumes in its revenue forecasting model that secured and unsecured property tax rolls will grow at the same rate;
- The Agency incorrectly assumes in its revenue forecasting model that assessed values will grow at the same base growth rate in all redevelopment areas;
- The Agency's methodology for anticipated new construction tends to overstate projected revenues;

- There are several technical errors in the Agency's revenue forecasting model;
- The Agency does not document the sources of or reasons for the econometric assumptions built into its revenue forecasting model;
- The Agency no longer provides a base case, best case, and worst case scenario for its five-year revenue projections;
- The Agency does not have written procedures or instructions for preparing its five-year revenue projections; and
- The Agency does not adequately monitor the number or amount of property tax appeals in redevelopment areas.

As a result, the Agency's 1991-92 through 1995-96 five-year projection contained about $2.5 million in correctable errors. In addition, the Agency's econometric assumptions in its revenue forecasting model are not known to the Board. Further, the Agency may not prepare its five-year revenue projections consistently or correctly. Finally, the Agency may not be adequately informed on property tax assessment trends. The Agency can improve the reliability of its five-year revenue projections by (1) documenting its computerized spreadsheets, (2) evaluating the econometric assumptions in prior years' revenue projections, (3) improving its revenue projection methodologies, (4) correcting technical errors in its revenue forecasting model, (5) establishing an economic policy committee to review the econometric assumptions in its revenue forecasting model, (6) preparing base case, best case, and worst case scenarios for its five-year revenue projections, (7) developing written instructions and procedures for preparing five-year revenue projections, (8) working closer with the Santa Clara County Assessor and County Counsel on property tax appeals in redevelopment areas, and (9) monitoring and reporting on the status of property tax appeals in redevelopment areas.

The Redevelopment Agency's Five-Year Revenue Projections

The Agency prepares a five-year revenue projection for its proposed Capital Improvement Program (CIP). The Agency's five-year revenue projections are the basis for two major types of Board decisions--bond financing and capital projects. Because the Agency leverages tax increments into bond proceeds, any revenue forecasting errors are magnified in terms of projected available funds for capital projects. For example, currently, each dollar of net tax increment revenue can be leveraged into about $11 or $12 in bond proceeds. Thus, even a small error in projected tax increments has a much larger impact on the amount of money available for redevelopment capital projects.

The Agency's forecast of tax increment revenues drives the preparation of the Agency's five-year CIP. The first year of the five-year CIP is the most critical because it is the Agency's annual Capital Budget. As shown in Table VIII, actual tax increment receipts have been within 1 percent to 2 percent of the Merged Area tax increments shown in the adopted annual Capital Budget for the past three years.

TABLE VIII

COMPARISON OF FORECASTED MERGED AREA FIVE-YEAR CAPITAL IMPROVEMENT PROGRAM TAX INCREMENTS TO PREVIOUS FORECASTS AND TO ACTUAL TAX INCREMENTS (In Millions)

In The Five-Year CIP	1987-88	1988-89	1989-90	1990-91	1991-92	1992-93	1993-94	1994-95	1995-96	1996-97
TAX INCREMENT FORECASTS FOR FISCAL YEARS IN THE FIVE-YEAR CIP										
1987-1992	$51.6	$61.1	$67.3	$74.8	$83.9					
1988-1993		56.6	61.7	68.5	77.2	$85.5				
1989-1994			60.0	65.4	72.6	78.7	$83.9			
1990-1995				66.4	71.1	79.7	86.0	$93.5		
1991-1996					69.7	75.7	81.1	90.9	$96.5	
1992-1997						72.3	77.4	83.5	90.2	96.5
Actual	$48.8	$51.6	$60.9	$64.8	$69.2					
OVER (UNDER) PREVIOUS PROJECTION/ACTUAL FOR FISCAL YEARS										
1987-1992	(2.8)	(4.5)	(5.6)	(6.3)	(6.7)					
1988-1993		(5.0)	(1.7)	(3.1)	(4.6)					
1989-1994			0.9	1.0	(1.5)	(6.8)				
1990-1995				(1.6)	(1.4)	1.0	2.1			
1991-1996					(0.5)	(4.0)	(4.9)	(2.6)		
1992-1997						(3.4)	(3.7)	(7.4)	(6.3)	
PERCENTAGE VARIANCE OF BUDGET TO ACTUAL	(5.4%)	(8.9%)	1.5%	(2.4%)	(0.7%)					

It is axiomatic that revenue forecasts become less reliable for years two, three, four, and five of a five-year model. Recently, that inherent uncertainty has been exacerbated by the downturn in most types of government revenues. Table VIII is a comparison of forecasted Merged Area five-year CIP tax increments to actual tax increments for 1987-88 through 1991-92. As Table VIII shows, the Agency has significantly lowered its revenue projections of several years ago. For example, in 1987-88 the Agency predicted that 1991-92 tax increments for the Merged Area would be $83.9 million. In 1988-89, 1989-90, 1990-91, and 1991-92 the Agency predicted that 1991-92 tax increments would be $77.2 million, $72.6 million, $71.1 million, and $69.7 million, respectively. Actual Merged Area tax increments for 1991-92 will be about $69.2 million. Thus, the Agency's 1987-88 prediction of 1991-92 Merged Area tax increments was off by $14.7 million or 18 percent of the original forecast.

The Redevelopment Agency's Revenue Forecasting Model

As with all revenue forecasting models, the reliability of the Agency's model is a function of the basic econometric assumptions built into the model and the methodology the Agency uses to convert those assumptions into projected revenues.

The Agency's model includes several years' history of the assessed valuation of redevelopment project areas by type of assessment (land, personal property, and improvements). The model applies various estimated growth factors to the previous year's assessed valuation for each type of assessment. In addition, the Agency uses trend analysis to estimate some assessed values and as a means to check estimated growth factors. The Agency also prepares estimates of tax rates and of the incremental assessed valuation due to new construction projects and absorption.[9]

The Agency's Project Economist annually obtains from the Santa Clara County Assessor's Office (Assessor's Office) the assessment rolls for all San Jose redevelopment project areas. Agency staff, in cooperation with the City of San Jose's Information Systems Department, compiles subtotals for the assessed value by redevelopment project area of the following:

- Land (both secured and unsecured);
- Improvements (both secured and unsecured);

[9]**Absorption Value** - The Agency estimate of the increase in the assessed value of personal property due to absorption of vacant space in redevelopment areas.

– Personal property (both secured and unsecured);

– State Board of Equalization (SBE) assessed utility land, improvements, and personal property;

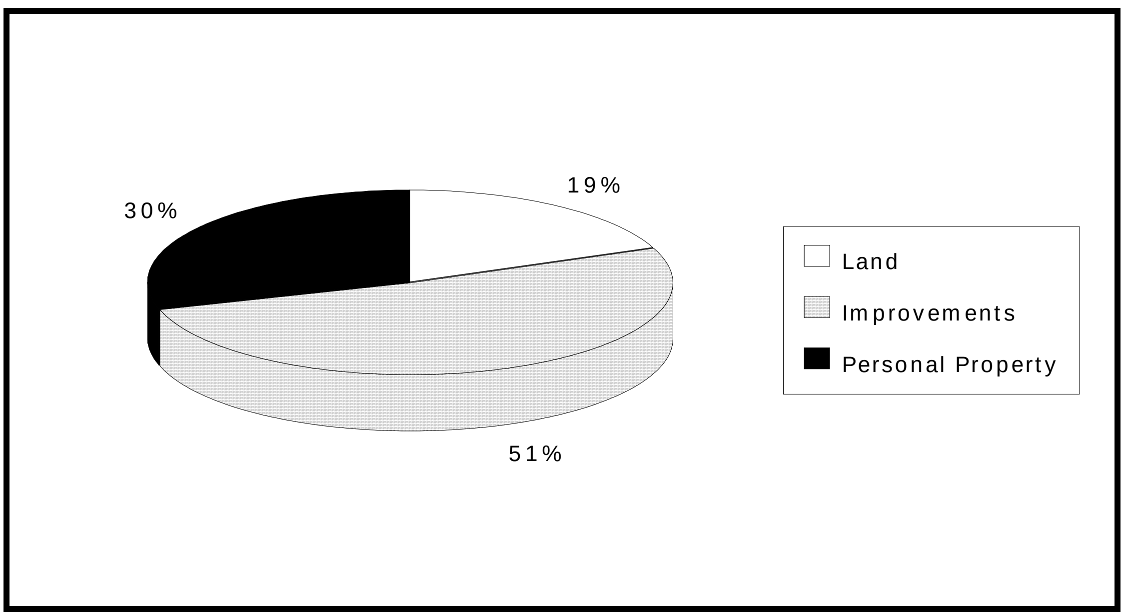
– Exemptions; and

– Base year assessed valuation.

Chart I depicts the percentage of total assessed valuations in 1990-91 of each of the major property tax components.

CHART I

PROPERTY TAX COMPONENTS
OF TOTAL ASSESSED VALUATION IN 1990-91



Santa Clara County (County) also provides the Agency with an annual certification of tax increment revenues for redevelopment project areas, which lists the following:

- Current year assessed valuation;
- Base year assessed valuation;
- Tax rates applied by tax rate area;[10] and
- Assembly Bill (AB) 454 utility revenues due to 1 percent allocation and debt service.

Agency staff compiles this information onto the five computerized spreadsheets the Agency uses to forecast revenues. Agency staff annually updates the historical information, prepares new forecasted growth rates, and compiles forecasted values on these spreadsheets. The spreadsheets are

- RFMLAND.XLS - Estimates the assessed value of land in redevelopment areas based on a trend analysis of previous years' assessed valuation;
- RFMIMPR.XLS - Estimates the assessed value of improvements in redevelopment areas based on (1) estimated percentage growth rate applied to previous years' assessed valuation of improvements plus (2) estimated assessed value of new construction projects;
- RFMPERS.XLS - Estimates the assessed value of personal property in redevelopment areas based on (1) estimated percentage growth rate applied to previous years' assessed valuation of personal property plus (2) estimated assessed value of personal property due to absorption of vacant space;
- RFMCONST.XLS - Estimates the incremental assessed value of improvements due to major new construction projects and the incremental assessed value of personal property due to absorption; and

[10] In 1991-92, there were a total of 171 tax rate areas in San Jose's 14 revenue-generating redevelopment project areas. The tax rate for each tax rate area is comprised of a basic rate of $1.00 and override rates of $0.05 to $0.16 per $100 of taxable value.

– RFMTOTAL.XLS - Summarizes the various estimates of assessed value and computes estimated tax increments using estimated tax rates.

The Agency's Computerized Spreadsheets Do Not Sufficiently Document The Agency's Revenue Projection Methodologies Or Computations

Our review revealed that, in spite of the complex interrelationships between the model's five spreadsheets, none of the spreadsheets include sufficient documentation in the form of titles, footnotes, or comments to adequately explain the categories or functions being used. This lack of documentation makes the spreadsheets extremely difficult to interpret. To understand the flow of information through the Agency's forecasting model, we prepared detailed flowcharts of the model's various components (Appendix B).

The complexity of the Agency's forecasting model is the cumulative result of a series of project economists' modifications to make the model as accurate as possible. As such, the current model is a pastiche of economic theories and assumptions. Because of its importance and the ever present possibility of staff turnover, the Agency's revenue forecasting model should be readily understandable, with explicitly stated rationales and assumptions and documented interrelationships of the various imbedded factors in the model, such as total expected growth rates.

For example, our review of the five spreadsheets in the Agency's revenue forecasting model revealed that Agency staff prepares an estimate of the expected annual percentage growth rates for the assessed value of improvements due to sales, appeals, and the Proposition 13 annual 2 percent inflation allowance. Agency staff then adds the estimated assessed value of a list of new construction projects to the forecasted value of improvements.

Graph II depicts the estimated assessed value of improvements in the Agency's 1990-91 revenue forecasting model and what those values would be using a straight trend line projection based on past values. For example, the assessed value of improvements in the Agency's revenue forecasting model in 1990-91 was approximately $3.5 billion. The Agency's projected assessed value of improvements in 1991-92 included a base growth factor of 4.5 percent (which added $200 million in valuation) and an additional $100 million for estimated new construction.[11] As a result, the Agency's revenue forecasting model projected an assessed value for improvements of approximately $3.8 billion in 1991-92. This represents an effective growth rate of 7.3 percent from 1990-91 to 1991-92. However, that effective growth rate of 7.3 percent did not appear anywhere on the spreadsheets in the revenue model where management or the Board could review and assess its validity. Thus, the effective growth rate for improvements in the model is higher than the growth factor that appears on the spreadsheet.

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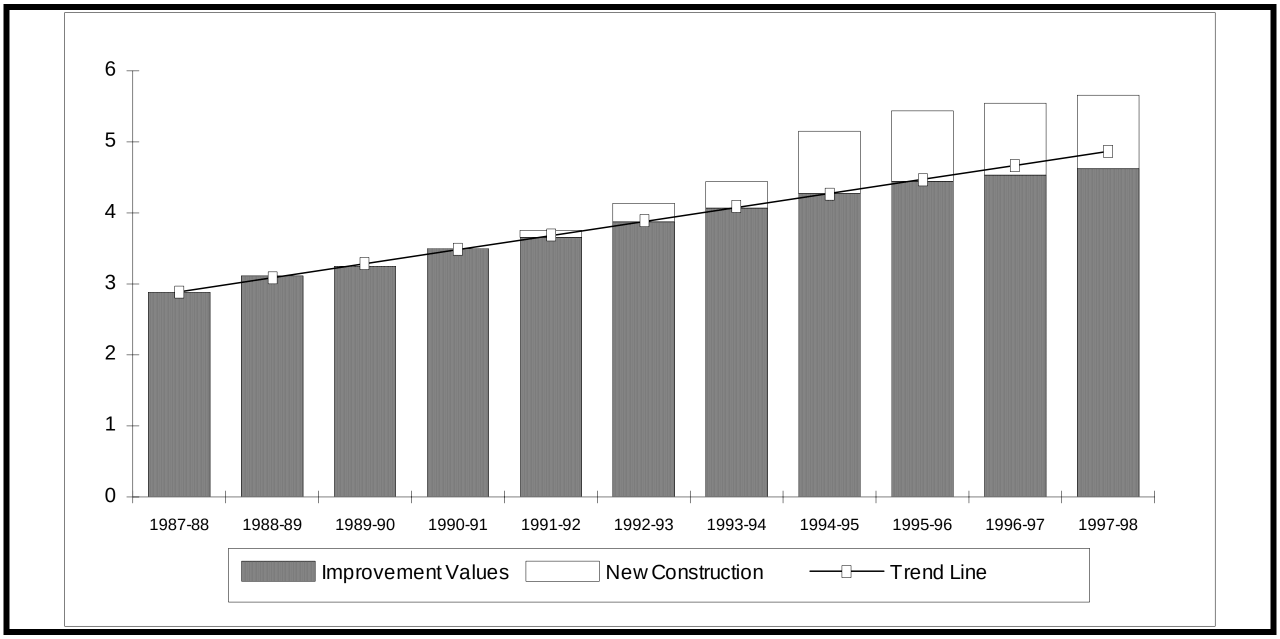
[11] Appendix B-3 (cells A5 and A65)

GRAPH II

COMPARISON OF ESTIMATED ASSESSED VALUE OF IMPROVEMENTS IN THE AGENCY'S 1990-91 REVENUE FORECASTING MODEL TO TREND LINE PROJECTIONS (In Billions)



The Agency Does Not Keep Adequate Records To Assess The Validity Of The Econometric Assumptions Used In Previous Revenue Projections

The Agency does not keep past runs of its revenue forecasting model. Consequently, the validity of Agency assumptions and the accuracy of Agency estimated growth rates in previous revenue forecasts cannot be assessed.

According to Agency staff, they enter actual revenue figures for the previous year into their forecasting model as part of preparing their new forecast. However, when historical trends are used in a revenue forecasting model, such as the Agency's, it is advisable to compare actual revenues to forecasted revenues as a means to evaluate the reliability of the model. For example, as detailed elsewhere in this report, we identified $2.5 million in errors in forecasted tax increments in the Agency's model that would have overstated 1991-92 through 1995-96 tax increments.

In our opinion, the Agency should retain copies of its revenue forecasts and the assumptions used therein. Further, the Agency should annually compare its forecasted revenues to actual revenues to assess the validity of the econometric assumptions it used in its prior years' revenue forecasting models.

The Agency Does Not Keep Adequate Records To Assess The Reliability Of The Assessed Values Of Land, Personal Property, Improvements, Utility Land, And Exemptions Used In Its Revenue Forecasting Model

Although the annual assessed valuations of land, personal property, improvements, utility land, and exemptions are critical components of the Agency's forecasting model, the Agency does not retain source documentation of these figures. During the course of our audit, we were able to verify that total assessed valuation in the revenue model reconciles to total assessed valuation on the County's certification statements. However, we were unable to verify the accuracy of the assessed valuation of the components of the forecast. This exposes the Agency to the risk that its forecasting model will apply percentage growth factors to incorrect assessed valuations or that the Agency may not detect errors in its forecast.

Because of the critical nature of the revenue forecasting model, the Agency should retain the source documentation for its model and periodically verify that the information in the model has not been inadvertently changed. Such proofing is essential given that whole columns and rows of information in computerized spreadsheets, like those in the Agency's forecasting model, are susceptible to being inadvertently altered.

The Agency Incorrectly Assumes In Its Revenue Forecasting Model That Secured And Unsecured Property Tax Rolls Will Grow At The Same Rate

The Agency's revenue forecasting model uses estimated growth rates for secured land, personal property, and improvements to calculate tax increments. The Agency applies these estimated growth rates equally to both the secured and unsecured assessment rolls.[12] In other words, the Agency's forecasting model assumes the same rate of growth for both secured and unsecured property.[13]

According to Agency staff, based on the data in their forecasting model, there has not been a significant enough difference in growth patterns to warrant separate estimates of secured and unsecured property. However, our review revealed that such separate treatment may, in fact, be warranted.

In 1990-91, unsecured property accounted for (1) 22 percent ($1.5 billion) of total assessed valuation in redevelopment areas, (2) 54 percent ($1.1 billion) of personal property valuation, and (3) 11 percent ($385 million) of improvement assessed valuation. Thus, unsecured property constitutes a significant portion of total assessed valuation in redevelopment areas.

Further, we found marked differences between the growth rates of secured and unsecured valuations for both personal property and improvements.

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[12] Appendix B-3 (cell A5) and Appendix B-4 (cell A5)

[13] **Secured property** - Property on which the property taxes are a lien against real estate.
Unsecured property - Property on which the property taxes are not a lien against real estate.

Specifically, while unsecured personal property grew by 50 percent from 1987-88 to 1990-91, secured personal property grew by only 9 percent. In addition, while the value of unsecured improvements increased by 40 percent from 1987-88 to 1990-91, secured improvements increased by only 19 percent over the same period.

We also found significant differences in the overall growth rates of the secured and unsecured property tax rolls. Specifically, from 1987-88 to 1990-91, the total unsecured property tax roll grew by 48 percent, while the secured property tax roll grew by only 16 percent. As a result, from 1987-88 to 1990-91, the unsecured roll grew from 18 percent of total assessed valuations in redevelopment areas to 22 percent of total assessed valuations.

While the Agency's revenue forecasting model applies only one estimated base growth rate factor to both the secured and unsecured valuation of personal property and only one growth factor to both the secured and unsecured valuation of improvements, the City of San Jose (City) tracks the growth rates of its secured and unsecured rolls separately. Accordingly, the City's Five-Year Economic Forecast is based on historically different growth rates for secured and unsecured property.

In our opinion, by applying the same growth rates for secured and unsecured assessment rolls in its revenue forecasts, the Agency is ignoring the fact that these two tax rolls are growing at markedly different rates. Accordingly, the Agency should monitor the growth rates for both secured and unsecured assessment rolls and use these growth rates to prepare separate tax increment forecasts for secured and unsecured property.

The Agency Incorrectly Assumes In Its Revenue Forecasting Model That Assessed Values Will Grow <u>At The Same Base Growth Rate In All Redevelopment Areas</u>

Our review revealed that the Agency incorrectly assumes in its revenue forecasting model that assessed improvement and personal property valuations will grow at the same base growth rates in all project areas.[14] For example, while the Agency assumed in its 1991-92 revenue model that the assessed valuation of improvements in all areas would grow at an annual base rate of 4.5 percent (plus new construction value), the actual assessed value of improvements grew by 9.2 percent in Century Center from 1989-90 to 1990-91, by 4.4 percent in Guadalupe-Auzerais, and by 96 percent in Edenvale East.

Further, we found that the Agency made a similar erroneous assumption in its 1991-92 revenue forecasting model for personal property. Specifically, the Agency assumed that the assessed valuation for personal property would grow by the same base rate of 3.5 percent (plus absorption value) in all redevelopment areas. However, we determined that from 1987-88 to 1990-91, the assessed valuation of personal property in Edenvale declined by 6 percent, while assessed valuation in the Rincon Expansion area increased by 129 percent.

Moreover, growth rates in total assessed valuation vary dramatically between redevelopment areas. For example, between 1990-91 and 1991-92, total assessed valuation in Rincon Expansion grew by 15 percent, while Edenvale East declined by 23 percent. Of particular concern, our review revealed that total assessed valuation declined in five redevelopment areas from 1990-91 to 1991-92. The total of these declines in assessed valuation was $62 million, or

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[14] Appendix B-3 (cell A5) and Appendix B-4 (cell A5)

about $752,000 in property tax revenues. Table IX shows the net reduction in assessed valuation and property tax revenues from 1990-91 to 1991-92 in these five redevelopment areas.

TABLE IX

REDEVELOPMENT AREAS SHOWING DECLINES IN TOTAL ASSESSED VALUATION AND RESULTANT ESTIMATED TAX DECREMENTS FROM 1990-91 TO 1991-92

Area	Net Decreased Valuation	Net Estimated Tax Decrements
Edenvale East	$35,654,422	$410,781
Olinder	7,787,151	116,724
Pueblo Uno	3,842,500	52,303
Rincon South	97,854	1,281
San Antonio	14,706,265	171,173
Subtotal	$62,088,192	$752,262

It should be noted that the Agency did not anticipate any of the decreased valuations shown above in its revenue forecasting model. In our opinion, the wide variation in assessed valuations from redevelopment area to redevelopment area shows the need for the Agency to analyze assessed valuation trends for each area and develop separate growth rates when warranted.

The Agency's Methodology For Anticipated New Construction Tends To Overstate Projected Revenues

Our review of the Agency's revenue forecasting model revealed that the Agency was overly optimistic when it anticipated the year in which new construction projects would hit the tax assessment rolls. For example, in its 1991-92 tax increment forecast, the Agency anticipated that the River Park Towers II building would be completed by March 1992 in order that the $598,000 of associated tax increments would be included in the 1992-93 tax rolls. However, as of July 1992, construction has been postponed on the River Park Towers II building. In addition, we noted that the Agency included in its 1991-92 revenue projection model about $92 million in new construction projects that were not completed in time to be on the 1991-92 tax assessment rolls. As a result, the Agency overstated its 1991-92 revenue projections by about $1 million.

Further, we noted that the Agency hired Bay Area Economics to prepare a construction project listing that identified when new construction projects in redevelopment areas could be anticipated. However, our review revealed that the Agency moved up the completion dates for several of the projects on the consultant's listing. For example, in its 1991-92 through 1995-96 CIP, the Agency moved up the completion dates for $174.6 million worth of construction projects, thereby adding $1.8 million to the Agency's tax increment forecast for that period.

Part of the reason the Agency staff moved up the dates for construction project tax assessments may be due to the column heading on its computer spreadsheet that says "Year Completed" when it should be labeled "Assessment Date." Adding to the confusion, the Agency's computer spreadsheet does not lag new construction values to account for the time between project completion and project assessment for tax purposes.[15]

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[15] Appendix B-5 (cell AE12)

There Are Several Technical Errors
In The Agency's Revenue Forecasting Model

The Agency has modified its revenue projection model over time using various project economists, each of whom made changes to the model. As a result, numerous technical errors have crept into the spreadsheets undetected. We noted several such errors in the revenue projection model for tax rates and the forecasted assessed value of land.

First, the Agency contracted with a consultant to forecast a variety of tax rates. Typically, override rates decline each year. However, Agency staff did not use some of the consultant's forecast rates in its revenue projection model. For example, the Agency assumed in its revenue model a water district tax rate of 0.0112 percent for most of the years in the model. This 0.0112 percent rate for water district bonds and charges that preceded the passage of Proposition 13 is in addition to the 1 percent tax rate specified in Proposition 13 and is levied only against land and improvement assessed values. The consultant the Agency hired had estimated an average water district tax rate of 0.0111 percent in 1990-91, stepping down to 0.0058 percent in 1999-2000.[16] By using the higher rate, we estimate the Agency inflated its projected five-year revenues by almost $700,000.

Second, the Agency apparently made another error when it input the estimated weighted average tax rates for land, improvements, and personal property for 1996-97 through 1999-2000. Estimated tax rates should show a steady decline.

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[16] The estimated decline in the tax rate is the result of water district bond retirement and growing assessed valuation in redevelopment areas which more than offsets the estimated 5 percent growth in the water district budget.

However, in the model, the tax rates for 1996-97 through 1999-2000 exactly match the tax rates for 1992-93 through 1995-96. By using higher tax rates, the Agency overstated estimated tax increment revenues for 1996-97 through 1999-2000 by as much as $8 million.

Finally, we identified the following methodological errors in the Agency's revenue projection model regarding the assessed valuation of land:

– <u>Computerized trend line function</u>.[17] The Agency incorrectly modified a computer-calculated straight line trend analysis. This tends to exacerbate assessed value variations from one year to the next.

– <u>Zero dollar assessed valuations</u>.[18] The Agency's revenue projection model showed zero dollar assessed valuations for land in the Century Center, Market Gateway, and Guadalupe-Auzerais redevelopment areas for 1983-84. This tends to skew future projected assessed valuations because of distorted trend lines based on a beginning zero value.

– <u>A typographical error in the trend line growth function</u>.[19] Agency staff inadvertently did not enter a value into the computerized spreadsheet.

As a result of the above correctable errors, the Agency's forecasted tax increments in its 1991-92 through 1995-96 five-year projection contained about $2.5 million in errors including $1.8 million as a result of errors in new construction estimates and $0.7 million in water district tax rate errors. Total forecasted tax increments for the five-year period were $426.3 million.

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17 Appendix B-2 (Calculation A96 to A5)
18 Appendix B-2 (cell A35)
19 Appendix B-2 (cell A121)

The Agency Does Not Document The Sources Of Or Reasons For The Econometric Assumptions Built Into Its Revenue Forecasting Model

The Agency's Director of Finance and Administration and Project Economist, in cooperation with consultants and other Agency staff, prepare the Agency's tax increment forecasts. The collective analysis and expectations of these individuals result in a variety of assumptions that drive the Agency's revenue forecasting model. However, our review revealed that the Agency typically does not keep and cannot produce documentation for the assumptions that were part of prior years' revenue projections.

Furthermore, the Agency does not provide the Board with specific information on the various assumptions the Agency builds into its revenue forecasting model. For example, neither the Agency's 1991-92 through 1995-96 CIP or Mid-year Capital Budget Review included specific information or specific revenue assumptions, such as estimated rates of assessed valuation growth for the various components in the model. As a result, the Board has no way to assess the reasonableness of the Agency's assumptions in its revenue forecasts.

Moreover, when the Agency prepared its proposed CIP for 1992-93 through 1996-97, it did not have time to run its revenue forecasting model. Consequently, the Agency used its best judgment as to how revenues would perform. However, the Agency did not indicate in the proposed budget it submitted to the Board that the Agency's revenue forecasting model was not used. Furthermore, the language the Agency used to describe its revenue forecasts for the 1992-93 through 1996-97 CIP is almost exactly the same as that for the previous year, when the revenue forecasting model was used. Thus, the Board had no reason to believe the revenue projections in the 1992-93 through 1996-97 CIP were any different than previous years' projections.

By way of contrast, the City Manager's Office of Management and Budget (OMB) provides the City Council with considerable detail in its Five-Year Economic Forecast and Revenue Projections regarding the economic variables in the City's projected five-year revenues. In addition, unlike the Agency, OMB provides the City Council with optimistic case, base case, and pessimistic case revenue and expenditure forecasts. In our opinion, the Agency should provide the Board with the same kind of specific information regarding the economic assumptions built into its revenue projections that OMB provides the City Council.

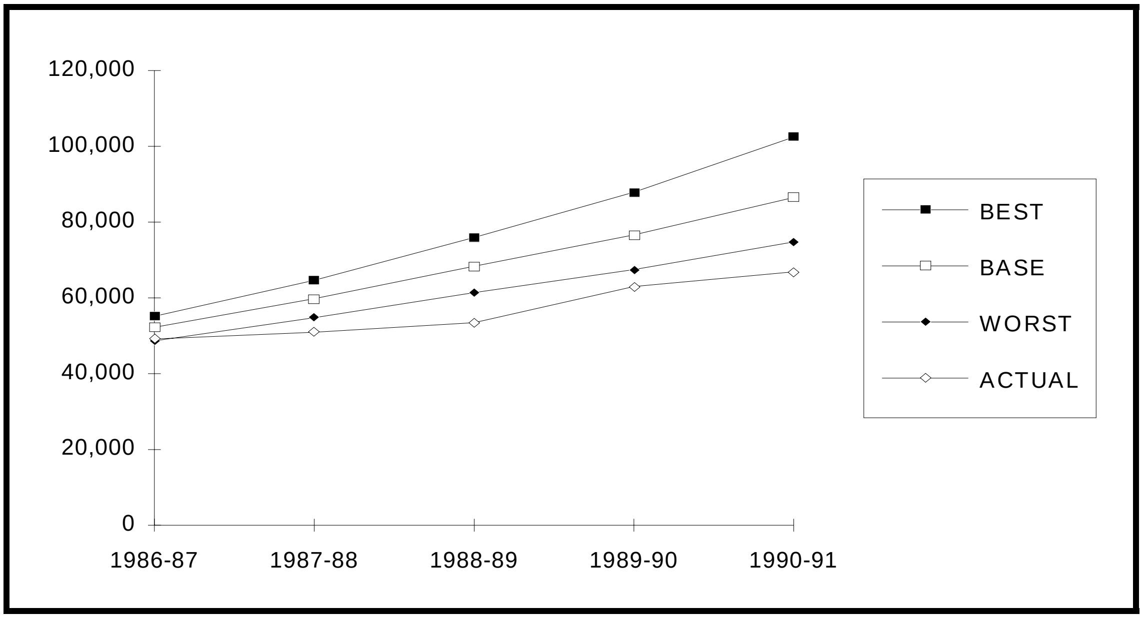
**The Agency No Longer Provides A Base Case,
Best Case, And Worst Case Scenario
For Its Five-Year Revenue Projections**

At one time the Agency presented best case, base case, and worst case revenue estimates to the Board. However, beginning with the 1987-88 through 1991-92 revenue projections, the Agency has prepared only a base case revenue forecast for the Board.

Our review of the last best case, base case, and worst case projection the Agency prepared revealed that actual revenues fell below the Agency's worst case estimate by $24 million as is shown in Graph III.

GRAPH III

COMPARISON OF ACTUAL TAX INCREMENTS TO THE BEST CASE, BASE CASE, AND WORST CASE FORECASTS THE AGENCY PREPARED FOR 1986-87 THROUGH 1990-91 (In Thousands)



As shown in Graph III, even the Agency's worst case scenario for 1986-87 through 1990-91 did not predict the continued weakness of the local real estate market or a slowing of tax increments in general. As a result, the Agency has consistently lowered projected revenues from one year to the next (see Table VIII).

The importance of the Agency's revenue projections increases as the Agency's debt levels rise and the Agency nears the end of its authority to issue bonds in the year 2001. Accordingly, the Board should be apprised of the economic assumptions built into the revenue forecasts it is using to make important fiscal and policy decisions.

In our opinion, one way to increase Board awareness would be for the Agency to prepare best case, base case, and worst case projections to show the effect alternative assumptions would have on the Agency's five-year CIP. To assist the Agency in preparing its best case, base case, and worst case revenue projections, an economic policy committee should be formed to assess the validity of the assumptions used in the forecasts and the reasonableness of the forecasted revenues. According to professional literature, such revenue committees are a useful component of the revenue forecasting process. Specifically, according to William J. Raftery's *Government Accounting And Financial Reporting Manual,*

> *The consideration of . . . factors in projecting revenue for the upcoming year and trends in longer-term income estimates is often best done by a staff budget committee. Such a committee should consist of key management and the professional staff who are closest to the various factors affecting the most important revenue sources . . . The budget revenue committee should . . . play a part in formulating the midyear budget report. The committee should continue to meet throughout the budget year in order to fine tune the estimates as new information is received. The projections may not always be perfect, but detailed analysis, identification of economic trends and local developments, and continual monitoring by a competent revenue team will produce the best possible results.*

It should be noted that the City Administration uses an Economic Policy Committee to review the major economic assumptions in the City's revenue estimates. The Assistant City Manager chairs the Committee, which includes representatives from the Budget, Economic Development, Mayor, and Policy Analyst offices; the departments of Finance and Planning; and the Redevelopment Agency. The membership of the Committee is intended to reflect a variety of disciplines and backgrounds with balanced perspective on the City's overall economic situation.

The Agency Does Not Have Written Procedures
<u>Or Instructions For Preparing Its Five-Year Revenue Projections</u>

Currently, the Agency does not have written operating procedures for preparing annual and five-year revenue forecasts. Several years ago, the Agency had a revenue forecasting procedure in its Administrative Procedures Manual. However, subsequent revisions of the manual have included only procedures with Agency-wide application. Procedures relating to individual position functions, such as the revenue forecasting procedure, were excluded from the Agency-wide manual.

This increases the risk that the Agency will not prepare its five-year revenue projections consistently or correctly and that assumption errors will go undetected. In our opinion, the Agency should prepare written procedures and guidelines regarding its revenue forecasting model to ensure consistent data entry, appropriate management review and approval, consistency from one year to the next, and an annual evaluation and assessment of forecasted results.

The Agency Does Not Adequately Monitor
The Number Or Amount Of Property Tax
Appeals In Redevelopment Areas

Over the past several years, Santa Clara County has experienced a dramatic increase in the number of property tax appeals filed, including the highest number of commercial appeals ever. The increase in the number and complexity of appeals has caused a significant processing backlog in the Assessor's Office and the Board of Assessment Appeals (Appeals Board). This backlog was documented in the February 1992 *Review of the County's System to Process Assessment Appeals* prepared by the Harvey M. Rose Accountancy Corporation for the Board of Supervisors.

According to the report, the growth in application filings is the result of

– Recent declines in the income-generating potential of commercial and industrial real property;

– Recent declines in values of residential real estate purchased at or near the peak period of 1989; and

– High technology manufacturing firms who contend that the assessed value of personal property and equipment exceeds its real value because of rapidly changing manufacturing techniques and relatively short product life cycles.

As of October 1991, there was a backlog of 3,335 appeals County-wide, representing over $11 billion in assessed valuation (see Table X). Furthermore, 127 applications showed disputed assessments of more than $10 million each.

TABLE X

ASSESSMENT APPEALS FILED WITH THE CLERK OF THE BOARD OF ASSESSMENT APPEALS OF SANTA CLARA COUNTY

Fiscal Year	Applications Filed	Pending Resolution As Of 10/91	Amount of Assessed Valuation In Dispute
1984-85	N/A	1	$ 6,155,442
1985-86	810	10	12,879,269
1986-87	856	24	118,984,033
1987-88	1,145	30	43,680,504
1988-89	1,231	74	658,921,773
1989-90	1,049	292	3,211,289,736
1990-91	2,109	1,513	6,705,954,841
1991-92 (as of 10/91)	N/A	1,391	428,892,949
Total	7,200	3,335	$11,186,758,547

Source: Harvey Rose Accountancy Corporation

Assessment appeals must be resolved within two years of the date they are filed with the Appeals Board. The Assessor's Office is responsible for making a determination of the current fair market value of the property. Typically, the Assessor considers acquisition cost, date of acquisition, recent comparable sales prices, and net income derived from the property.

The majority of Appeals Board actions, including some of the largest appeals, are approvals of stipulated agreements between the Assessor's Office and the property owner. For example, between 1984-85 and 1990-91, stipulated agreements accounted for $565 million (83 percent) of reduced assessments due to appeals.

Property owners may dispute the County Assessor's opinion and request a hearing in front of the Appeals Board. The Appeals Board has broad rules of evidence and has final authority in resolving assessment appeals. The Appeals Board cannot reconsider or rehear an application once the appeal has been decided. At the Appeals Board hearing, both the appellant and the County Assessor may be represented by legal counsel. County Counsel provides this service to the Appeals Board. The San Jose Redevelopment Agency is not notified of these appeals and is not represented in the process.

Our review revealed that assessment appeals may have an indirect impact on property taxes in redevelopment areas. In fact, recent declines in assessed valuation in some redevelopment areas may be partially the result of assessment appeals. In 1991, assessed valuation in San Jose Redevelopment Agency project areas represented almost 7 percent ($7 billion) of total assessed valuation in the County ($104 billion). In addition, 27 percent of the appeals County-wide were on commercial and industrial real property. Between 1984-85 and 1990-91, a total of

1,978 property tax appeals were completed representing $3.1 billion in disputed valuation. These appeals resulted in $683 million in reduced assessed valuations, 22 percent of the amount in dispute.

Because of the potential impact of future appeals, the Agency should monitor the assessment appeals process to ensure that the Agency's interests are protected. For example, the Fairmont Hotel (in the San Antonio redevelopment area) has been the subject of several assessment appeals. In 1988-89, the hotel was assessed at $104 million, but the hotel successfully appealed $29 million of its assessed value (an estimated adjustment of $315,000 to its property tax bill). In 1989-90, the hotel successfully appealed $21 million of its $107 million assessed value (an estimated adjustment of $233,000 to its property tax bill). These one-time adjustments were stipulated by an agreement between the Assessor's Office and the property owner and were approved by the Appeals Board. Likewise, the assessed valuation of the hotel (the basis for its tax increments) has declined as follows:

Fiscal Year	**Assessed Valuation**
1988-89	$104 million
1989-90	107 million
1990-91	92 million
1991-92	87 million
1992-93	87 million

Furthermore, our review revealed at least 38 outstanding assessment appeals in redevelopment areas for 1990-91 and 46 outstanding appeals for 1991-92. The Agency is not currently notified of pending or resolved appeals in redevelopment areas. Nevertheless, the Agency should do what it can to lessen the uncertainty due to outstanding appeals by working closer with the County Assessor and

County Counsel on property tax appeals in redevelopment areas and monitoring and reporting on the status of property tax appeals in redevelopment areas.

CONCLUSION

Our review of the Agency's revenue forecasting model indicates that the reliability of the model can be improved. Specifically, we found that the Agency's 1991-92 through 1995-96 five-year projection contained about $2.5 million in correctable errors. We also found that assumptions in the revenue forecasting model are not clearly documented and are not conveyed to the Board. In addition, written instructions and procedures for preparing the five-year revenue projections are needed to ensure accuracy and consistency. Furthermore, to address the problem of uncertainty in the forecast, the Agency should prepare best case, base case, and worst case forecasts and should review those forecasts with an economic policy committee. Finally, the Agency may not be adequately informed on declining property assessment trends and should work closer with the County Assessor and County Counsel on property tax appeals in redevelopment areas. It should also monitor and report on the status of appeals in redevelopment areas.

RECOMMENDATIONS

We recommend that the Redevelopment Agency:

Recommendation #7:

Prepare separate procedures and documentation for the revenue forecasting model, including explanatory titles, notes, and comments in the spreadsheets, that (1) distinguish data critical to the revenue forecast from information used for other purposes and (2) clearly indicate sources of information. (Priority 3)

Recommendation #8:

Annually assess the accuracy of its revenue forecasting model by comparing actual revenues to forecasted revenues, assessing the validity of the assumptions built into the model, and retaining copies of past revenue forecasting models. (Priority 3)

Recommendation #9:

Improve its revenue projection methodologies by

- Monitoring growth rates for both secured and unsecured assessment rolls within each redevelopment area and developing separate growth rates based on historical trends;
- Retaining the source documentation for the actual values entered into the revenue forecasting model and reviewing the figures transcribed into the computer spreadsheets for accuracy;
- Calculating and displaying the total assumed growth rates in assessed valuation for improvements and personal property for each redevelopment area after additions; and
- Changing the column heading on its computerized spreadsheet from "Year Completed" to "Assessment Date" or modifying its spreadsheet to allow for the time between a project's completion and the property's assessment for tax purposes.

(Priority 3)

Recommendation #10:

Correct technical errors in its revenue forecasting model by

- Modifying the use of the trend function by varying the number of years of actual data upon which the trend line is based;
- Revising the formulas that compute the percentage change of a trend function;
- Removing zero dollar assessed valuations from the trend line function for the assessed valuation of land;
- Revising its water district tax rate forecasts;
- Correcting the errors in 1996-97 through 1999-2000 tax rate forecasts;
- Correcting a typographical error in the trend line growth formula in the land spreadsheet;
- Correcting an error in the reported actual tax rate for 1989-90; and
- Establishing criteria for estimating the expected assessment date for new construction projects within redevelopment areas.

(Priority 3)

Recommendation #11:

Establish a formal economic policy committee to review the econometric assumptions in its revenue forecasting model. (Priority 3)

Recommendation #12:

Prepare best case, base case, and worst case scenarios for its five-year revenue projections. (Priority 3)

Recommendation #13:

Develop written instructions and procedures for preparing its five-year revenue projections. (Priority 3)

Recommendation #14:

Enter into discussions with the Santa Clara County Assessor and County Counsel to

- Determine the downside risk to tax increment revenues from outstanding assessment appeals;
- Agree to a notification procedure when appeals are filed within City of San Jose redevelopment project areas; and
- Provide analytical support to the County Assessor when appeals are filed in redevelopment project areas.

(Priority 2)

Recommendation #15:

Monitor and report to the Redevelopment Agency Board property tax appeals within redevelopment areas, including the known and estimated effects of appeals on forecasted tax increments. (Priority 2)

FINDING III

OPPORTUNITIES EXIST TO ENHANCE THE REDEVELOPMENT AGENCY BOARD'S ABILITY TO ASSESS THE STATUS OF THE AGENCY'S CAPITAL IMPROVEMENT PROGRAM

San Jose's adopted redevelopment plans stipulate that the debt financing necessary to complete redevelopment must be in place by December 31, 2001. Accordingly, the Redevelopment Agency (Agency) needs to make definitive and quantifiable plans to facilitate identifying and funding the most crucial capital projects by the end of the year 2001. However, our review of the Agency's Capital Improvement Program (CIP) revealed that

- The Agency has not developed the definitive goals, workplans, and cost estimates that the Redevelopment Agency Board (Board) requested in 1987;
- During the past three fiscal years, the percentage of the Agency's annual Capital Budget expended or encumbered has declined; and
- The Agency's annual Capital Budget lacks necessary financial information.

As a result, the Board and the public do not have the information needed to assess the status of San Jose's redevelopment effort. To facilitate the Board's policymaking authority, the Agency should (1) implement Board-adopted City Auditor recommendations regarding definitive goals, workplans, and cost estimates and (2) incorporate additional and more descriptive financial information in its annual Capital Budget.

San Jose's Adopted Redevelopment Plans Stipulate
That Debt Financing To Complete Redevelopment
<u>Must Be In Place By December 31, 2001</u>

The adopted redevelopment plans for San Jose's redevelopment area stipulate that any

> *. . . loans, advances or indebtedness to finance this Project in whole or in part shall be established before December 31, 2001, provided that repayment of such loans, advances or indebtedness may extend beyond this date.*

According to California Community Redevelopment Law, every redevelopment plan shall include

> *A time limit on the establishing of loans, advances, and indebtedness to finance in whole or in part the redevelopment project. Such loans, advances, or indebtedness may be repaid over a period of time longer than such time limit. No loans, advances, or indebtedness to be repaid from such allocation of taxes shall be established or incurred by the agency beyond such time limitation. Such time limitation may be extended only by amendment of the redevelopment plan.*

Because of the time limitations in its redevelopment plans, the Agency has only five years beyond 1995-96 to issue bonds and fund major redevelopment projects. With limited capital funding available between now and the year 2001, it is essential that the Board place added emphasis on a planning process that will help ensure that sufficient funds are set aside for the most critical capital projects.

It should be noted that the Board may amend redevelopment plans. In amending the plan, the Board must include the same findings that are in the original adoption of a redevelopment plan. These findings include determinations that (1) the project area is blighted, (2) the elimination of blight could not be reasonably expected to be accomplished by private enterprise acting alone without the aid and assistance of the Agency, and (3) increment financing will not cause significant financial burden or detriment on any taxing agency deriving revenues from a project area. In addition, amendments to redevelopment plans are subject to referendum.

The Agency Has Not Developed The Definitive Goals, Workplans, And Cost Estimates That The Redevelopment Agency Board Requested In 1987

The December 1987 City Auditor's Office report entitled *A Review of the Redevelopment Agency's Capital Improvement Program* recommended that the Agency develop definitive goals, workplans, and cost estimates for each project area. As of February 13, 1992, the Agency has reported only partial implementation of the following recommendations.

City Auditor's Recommendation	Response From Redevelopment Agency As of February 13, 1992
#1 - Develop definitive and quantitative goals and objectives for each project area and prepare a work program to accomplish those objectives.	*The Economic Analyses and Market Studies performed by EIR for Rincon and Edenvale are now complete and have been accepted by the Agency Board. The Downtown Working Review Committee has completed its work, and its report has also been accepted by the Agency Board. The Downtown Plan, which contains quantitative goals for development, will be adopted by the Board once the EIR is complete.* ***Status**: Partly Implemented* ***Target Date:** 09-30-92.*

City Auditor's Recommendation	Response From Redevelopment Agency As of February 13, 1992
#2 - Develop a cost estimate for the completion of all redevelopment project areas and identify essential projects contemplated for each area.	*The Downtown Plan and accompanying EIR are critical elements in the identification of infrastructure needs for the project areas. Adoption of those documents will provide formal recognition of essential projects.* *The scope of the plan exceeds the Agency's foreseeable financing capacity. Therefore, the Agency cost estimate for completion becomes a function of its future financing opportunities and its authority to issue bonds, which is scheduled to expire in 2001. Bonding capacity between now and 2001 is determined by economic factors which cannot be predicted with certainty over the long term.* ***Status:*** *Partly Implemented* ***Target Date:*** *09-30-92*

Agency staff has expressed concern that a rigorous planning process may impair the Agency's flexibility and be counterproductive. Agency staff has also mentioned that the Agency's authority to issue bonds could be extended beyond the current date of 2001 to secure financing.

In our opinion, the Agency should give the Board capital program status information, such as budgets, work programs, and achievable schedules for completion of existing project areas. For example, the Department of Public Works prepares a quarterly Capital Projects Status Report of key capital projects which includes (1) original and revised budget amounts, (2) project completion target dates, and (3) descriptions of project statuses. Furthermore, the San Francisco Redevelopment Agency's (SFRA) mission statement states, in part, that

> *The SFRA still has some unfinished business which must be completed. It must complete these existing commitments on time and within specified budgets so that scarce tax dollars available to the SFRA can be used to tackle citywide*

> *goals of increased affordable housing production and economic development initiatives, particularly to serve lower income residents. Fixed budgets and achievable schedules for the completion of these existing project areas will be developed.*

The Agency should implement the preceding outstanding recommendations that the City Auditor made in 1987 and that the Board subsequently approved. In addition, the Agency should identify and recommend to the Board funding for the most crucial capital projects between now and the year 2001.

During The Past Three Years, The Percentage Of The Agency's Annual Capital Budget Expended Or Encumbered Has Declined

The City Council has established policies regarding the City of San Jose's (City) five-year CIP. These policies distinguish between the City's five-year CIP and the City's annual Capital Budget as follows:

> *After it is adopted by the City Council, it is a non-binding assertion of future intent only. However, when an appropriation for the annual capital budget is adopted as part of the regular budget, it represents the amount which will be used to implement part of the Capital Improvement Plan in the coming year.*

City Council policy also states that

> *The Annual Capital Budget shall include only those projects which can reasonably be accomplished in the time frame indicated. Multi-year budgeting of projects shall be used to ensure a reasonable time frame for projecting costs.*

In addition, the instructions for preparing the City's 1992-93 through 1996-97 five-year CIP state that because of needed coordination between departments, such as the Department of Public Works, "*It is absolutely critical that programs reflect realistic expenditure and timetable estimates.*"

Our review revealed that during the past three fiscal years, the percentage of the Agency's capital budget expended or encumbered has declined. For example, in 1988-89, the Agency spent or committed 88 percent of total funds available, which includes the adopted budget, budget amendments, and prior year carryover encumbrances. However, in 1989-90 and 1990-91, the Agency spent or committed only 59 percent and 61 percent of its total funds available, respectively.

Traditionally, the Agency's capital budgeting philosophy has been to assume bonding to capacity and then identify the capital projects the Agency and/or the Board wants to fund. According to Agency staff, the Agency includes projects in its annual Capital Budget that it may not be able to complete or even substantially complete because (1) appropriations must be large enough to cover the entire contract even though the work may not be completed or funds spent during the current fiscal year and (2) the Agency needs the flexibility to be able to begin projects as opportunities arise. As a result, the Agency's Capital Budget includes capital projects that are not completed or sometimes not even started. For example, in 1990-91, the Agency's adopted annual Capital Budget included $210 million in capital projects. At year-end, the Agency's adjusted Capital Budget showed only $153 million in anticipated capital expenditures, $57 million less than what was shown on the adopted annual Capital Budget. However, the Agency spent and/or committed only $107 million--$103 million less than was shown on the original adopted annual Capital Budget. Although all adjustments must be approved by the Board during the course of the year, cumulatively they show the need for additional information on the adopted Capital Budget.

The Agency's Annual Capital Budget Lacks Necessary Financial Information

Our review of the Agency's Capital Budget revealed that, unlike the City's Capital Budget, the Agency does not show total actual expenditures and appropriations to date on projects, including prior years. Moreover, while the Agency's Quarterly Status Reports for Redevelopment Projects show project status, they do not include expenditure information.

As a result, the Board and/or the general public may not have adequate information to assess actual expenditures on or progress to date for capital projects. Furthermore, without such information, planning for the remaining life of redevelopment in San Jose may be impaired.

The City's Five-Year Economic Forecast shows the level of discretion available by presenting proposed expenditures as (1) committed cost increases that are considered unavoidable, (2) policy additions following a firm City Council policy previously established, and (3) extended additions that represent costs that the City Council still needs to review and approve. Unlike the City Administration, the Agency does not categorize projected expenditures by priority.

CONCLUSION

Opportunities exist to improve the Board's ability to assess the status of redevelopment efforts. The Agency can provide the Board with definitive goals, workplans, and cost estimates that the Board had previously requested. In addition, when preparing the annual Capital Budget, the Agency should include additional and more descriptive financial information. This information will serve to assist the Board in its oversight responsibility for identifying and funding the most crucial capital projects by the end of the year 2001.

RECOMMENDATIONS

The Redevelopment Agency should:

Recommendation #16:

Develop definitive and quantitative goals and objectives for each project area and prepare a work program to accomplish these objectives. (Priority 2)

Recommendation #17:

Develop a cost estimate for the completion of all redevelopment project areas and identify the essential projects contemplated for each area.
(Priority 2)

Recommendation #18:

Incorporate additional and more descriptive financial information in its annual Capital Budget, including

- Prior years' expenditure and appropriation history on Capital Budget project detail sheets;
- A notation system for distinguishing multi-year capital projects in the annual Capital Budget for which funds appropriated may not be spent during the current fiscal year; and
- A classification system to show the level of discretion available in the Capital Budget, including a periodic analysis of expenditures as committed, policy additions, and extended additions in the five-year Capital Budget.

(Priority 3)

FINDING IV

THE REDEVELOPMENT AGENCY NEEDS TO IMPROVE ITS ADMINISTRATION OF CONTRACTS OF $20,000 AND UNDER

The Redevelopment Agency (Agency) may award contracts of $20,000 and under without prior Redevelopment Agency Board (Board) approval. These contracts are subject to the Agency's informal purchasing process. From July 1, 1989, through December 31, 1991, the Agency executed and/or completed 210 contracts of $20,000 and under, including multiple contracts to the same vendors for similar services. In addition, our review revealed that the Agency needs to include written procedures in its Administrative Procedures Manual regarding service contracts relating to construction projects, the solicitation and handling of sealed bids, and a policy against splitting purchases or contracts to avoid a formal bidding process.

The Agency's Purchasing Process

The Agency issues its own purchase orders, prepares its own contracts, and is not subject to the City of San Jose's (City) purchasing code. The Agency's Administrative Procedures Manual prescribes the following purchasing processes:

- Purchases (other than equipment) of $3,000 or less. Division directors authorize such purchases by submitting invoices to the Finance and Administration Division for payment; no purchase order is required. Approval of the Executive Director is obtained prior to payment.

- Purchases over $3,000 but no more than $20,000. These purchases are subject to an informal purchasing process.

- Purchases over $20,000. These purchases require a formal purchasing process unless an exemption applies.

Agency policy is to purchase administrative supplies from downtown vendors when possible. Agency purchase orders are used to acquire goods, services, materials, or equipment bought through a single transaction from a single vendor. The Agency also issues open purchase orders for a specified period of time and/or a not-to-exceed dollar amount for a single vendor.

Informal Purchasing Process For Contracts $20,000 And Under

Agency procedures permit an informal purchasing process when the amount of the purchase is more than $3,000 but no more than $20,000. In these cases, a formal purchasing process is not required. Under an informal purchasing process, the Agency may obtain price quotations from three different vendors either by telephone or in writing. The requester completes a Purchase Request Order and submits it to the Agency's Finance and Administration Division which prepares a purchase order. The Director of Finance and Administration and the Executive Director subsequently approve the purchase order. A purchase may be completed either by purchase order or by contract. The Director of Finance and Administration, in consultation with General Counsel when necessary, determines when a purchase order, as opposed to a contract, is appropriate to acquire goods or services.

Although an informal purchasing process differs from a formal purchasing process, the objectives of the two processes are essentially the same--to obtain goods and services economically, with fairness and impartiality towards vendors.

Quarterly Contract Status Reports

The Executive Director of the Agency submits to the Board a quarterly report listing the contracts of $20,000 and under that the Agency executed and/or completed during the previous quarter. The purpose of the report is to inform the Board of the contracts the Executive Director authorized during the previous quarter.

We reviewed these quarterly reports for 1989-90 and 1990-91 and the first two quarters of 1991-92. During those ten quarters, the Agency executed and/or completed 210 contracts of $20,000 and under with a total value of $2.8 million. As shown in Table XI, the average value of the Agency-authorized contracts from July 1989 through December 1991 was $13,340.

TABLE XI

SUMMARY OF REDEVELOPMENT AGENCY EXECUTED AND/OR COMPLETED CONTRACTS OF $20,000 AND UNDER (JULY 1989 THROUGH DECEMBER 1991)

Reporting Period	Number	Authorized Amount
1989-90 - Q1	24	$ 302,427
1989-90 - Q2	7	91,412
1989-90 - Q3	28	346,012
1989-90 - Q4	31	348,513
Fiscal year total	**90**	**$1,088,364**
Average per quarter	**23**	**272,091**
1990-91 - Q1	30	$ 469,232
1990-91 - Q2	14	180,907
1990-91 - Q3	32	462,608
1990-91 - Q4	8	126,400
Fiscal year total	**84**	**$1,239,147**
Average per quarter	**21**	**309,787**
1991-92 - Q1	23	$ 321,624
1991-92 - Q2	13	152,290
Fiscal year total	**36**	**$473,914**
Average per quarter	**18**	**236,957**
TOTAL	**210**	**$2,801,425**
Average per quarter	**21**	**280,142**
Average per contract	**1**	**13,340**

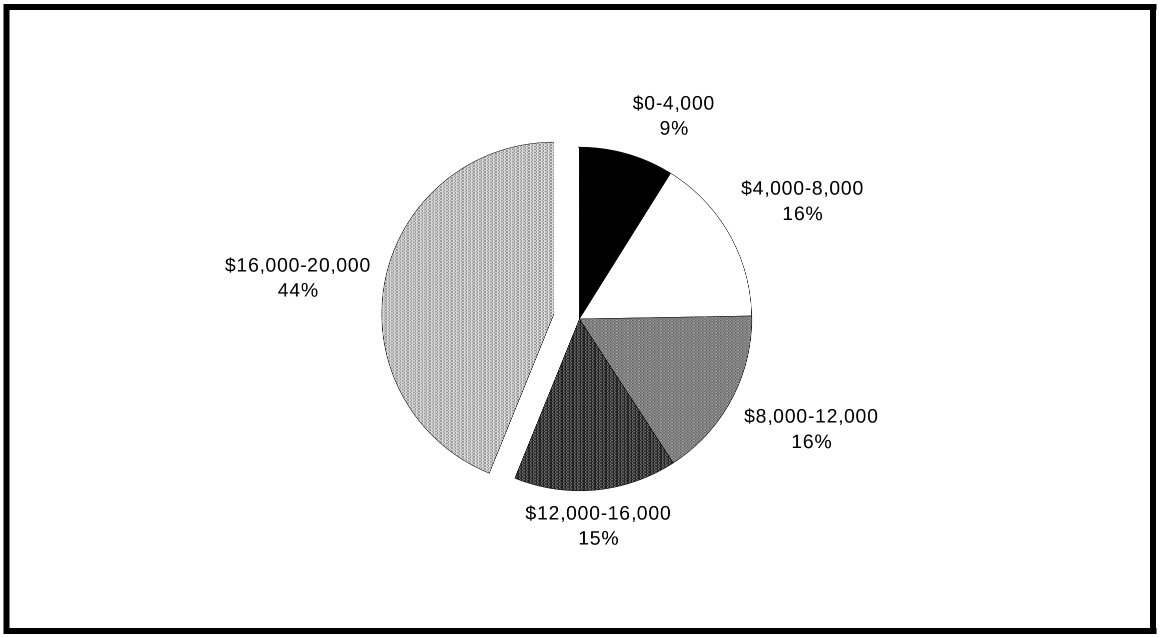
Source*:* Redevelopment Agency quarterly status reports of contracts $20,000 and under

The Agency Awarded Multiple Contracts $20,000 And Under To The Same Vendor

During the period under review, the Agency reported awarding contracts to 141 different vendors. Of these contracts, the Agency reported that 44 percent were authorized for $16,000 to $20,000, including 73 contracts authorized for $20,000 (see Chart II).

CHART II

AGENCY-AWARDED CONTRACTS OF $20,000 AND UNDER
FROM JULY 1989 THROUGH DECEMBER 1991



SOURCE: Redevelopment Agency quarterly contract status reports of contracts $20,000 and under

In several instances, the Agency awarded more than one contract to the same vendor in one fiscal year. Specifically, we noted that the Agency awarded two or more contracts in the same fiscal year to 20 vendors (see Appendix C). For example, from July 1, 1989, through December 31, 1991, the Agency awarded 23 contracts totaling $262,000 for appraisal services to eight vendors, of which one vendor--Carneghi, Bautovich & Partners--received seven separate contracts totaling $97,660. Furthermore, of those seven contracts the Agency awarded to the same vendor, five contracts totaling $85,000 were awarded during one fiscal year.

The Agency also awarded seven contracts for goodwill appraisals totaling $95,000 to two vendors, including four contracts to Desmond & Marcello ($70,000 total) and three contracts to Hemming & Morse ($25,000 total). In addition, the

Agency awarded 16 contracts worth $243,000 for legal and litigation services to seven vendors (see Appendix D). Of these seven vendors, one--Wahler Associates--received seven contracts in one fiscal year totaling $90,000.

In awarding multiple contracts that cumulatively total more than $20,000 to one vendor, the Agency may jeopardize its competitive bidding goals. While formal bidding may be seen as unduly complicating the Agency's contracting process, it may in fact save the Agency time and expense. Specifically, the Agency may already be incurring additional administrative costs when it prepares more than one contract for the same service with the same vendor. In our opinion, the Agency should either disperse its $20,000 and under contracts to as broad a base of vendors as possible or consolidate several contracts for the same service into a single contract that can be formally bid.

Handling Of Construction Project Service Contracts
Over $5,000 Should Be Carefully Monitored

California's Public Contract Code (Code) requires that, when the expenditure required for a public project exceeds $5,000, it shall be contracted for and let to the lowest responsible bidder after notice. The Code specifically requires that any grading, clearing, demolition, or construction a public agency undertakes shall be done by contract after competitive bids if the cost of such work exceeds $5,000. The Code also requires that "*to the greatest extent feasible, opportunities for training and employment arising from any contract for work to be performed in connection with any redevelopment project shall be given to the lower income residents of the project area.*"

Our review revealed that several construction projects appear repeatedly on the Agency's quarterly contract status reports of contracts $20,000 and under. For example, during the ten quarters we reviewed, 20 contracts totaling $285,000 were awarded to 13 vendors related to the Arena; ten contracts totaling $130,000 were awarded to nine vendors related to the Fallon House; and six contracts totaling $97,000 awarded to six vendors related to the Rescue Mission relocation (see Appendix E). While the scope of services listed for these contracts in the quarterly contract status reports reveal that they appear to be service-oriented contracts rather than construction-oriented contracts, the Agency's written procedures should nonetheless require consultation with legal counsel as to whether the $5,000 limit applies to these and similar contracts.

A Formal Bidding Process For Contracts Over $20,000
Is Not Documented In The Agency's Administrative Procedures Manual

Agency procedures specify that purchases of services, supplies, materials, or equipment that exceed $20,000 require a formal purchasing process. The Agency's Administrative Procedures Manual specifies that written quotes from at least three vendors are required. The Agency's Finance and Administration Division and the requester evaluate the quotes to select a vendor. For proposed purchases that exceed $20,000, the requesting Agency division prepares a memo recommending that the Board award the purchase or contract to the vendor selected.

The City Charter and Municipal Code specify the City's purchasing requirements. To achieve its purchasing goals, the Municipal Code prescribes competitive, sealed bidding as the City's primary method of procurement for purchases of materials, supplies, and equipment exceeding $20,000. In contrast, the Agency's Administrative Procedures Manual does not specifically require a competitive, sealed bidding process. [20]

Furthermore, while the Municipal Code includes a policy against splitting purchases or contracts "*when the need has been identified for multiples of items, related items, or similar items, which are ordinarily available from the same vendor or manufacturer*," the Agency's Administrative Procedures Manual does not include such a policy.

In our opinion, the Agency should include in its Administrative Procedures Manual written procedures regarding the solicitation and handling of sealed bids and should include a policy against splitting purchases or contracts to avoid a formal bidding process.

CONCLUSION

Our review of the Agency's quarterly contract status reports revealed that the Agency has awarded multiple contracts of $20,000 and under to the same vendors. As a result, the Agency may jeopardize competitive bidding goals. In addition, based on state law, the Agency should solicit advice and develop a policy regarding the handling of construction project service contracts. Furthermore, a formal bidding process for contracts over $20,000 should be documented in the Agency's Administrative Procedures Manual along with a policy against splitting purchases or contracts to avoid a formal bidding process.

RECOMMENDATIONS

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[20] It should be noted that the Agency does conduct a formal competitive bidding process for its construction projects even though its Administrative Procedures Manual does not require such a process.

We recommend that the Redevelopment Agency:

Recommendation #19:

Develop policies and procedures regarding the awarding of multiple contracts of $20,000 and under to ensure the dispersal of these contracts to as broad a base of vendors as possible or, alternatively, to consolidate several contracts for the same service into a single contract that can be formally bid. (Priority 3)

Recommendation #20:

Include written procedures in its Administrative Procedures Manual regarding service contracts relating to construction projects, the solicitation and handling of sealed bids, and a policy against splitting purchases or contracts to avoid a formal bidding process. (Priority 3)

OTHER PERTINENT INFORMATION

Santa Clara County's Method Of Calculating
The Agency's Property Tax Increments

Santa Clara County (County) calculates and remits property tax revenues due to the Redevelopment Agency (Agency). The County prepares an annual estimate of redevelopment excess value and tax increments for all redevelopment areas in the County. The estimates are based on (1) the certified tax roll of July 1 of the fiscal year for each tax rate area within each redevelopment project area, (2) the base year assessed valuation for that project area, and (3) the tax rate for that tax rate area. The County disburses these funds, in full, to the Agency over the course of the year. The Agency also receives tax revenues from certain utility properties; however, unlike tax increments, those estimates are adjusted prior to final payment to reflect actual receipts. The County also processes supplemental assessments separately and credits these revenues to the Agency.

The County's calculation of Agency tax increment revenues assumes that tax collections are 100 percent of levy. Historically, the County has allocated 100 percent of the tax levy to the Agency. Generally, there are no deductions for delinquencies, appeals, or impoundments. As a result, tax roll adjustments after July 1, whether positive or negative, are not passed on to the Agency. This method is commonly referred to as the "Modified Teeter Plan." Although the County has historically allocated tax revenues to the Agency under the Teeter Plan, there is no assurance that the County will continue to do so in the future.

According to Agency staff, the tax increment certainty afforded by the Teeter Plan is worth about 10 basis points on the Agency's bond coupon rates. Furthermore, according to the Agency, *Under this plan, the Agency receives 100 percent of its incremental portion of the taxes assessed. There is no downside risk from delinquencies, or Proposition 8 appeals, and there is no upside benefit from penalty collections or other one-time windfalls, except as they are reflected in the supplemental roll. This certainty of allocation is beneficial to the Agency in its bonding program because no allowance for delinquencies is necessary. It also ensures a higher degree of financial stability throughout the fiscal year.*

Nonetheless, during the course of our audit, we were unable to determine whether the Agency is the net winner or loser under this plan. Apparently, the County is unable to provide management reports which would allow comparison of actual revenues to tax levy for redevelopment areas. Specifically, our review revealed two areas of undetermined importance to future Agency revenues:

– Cash recoveries resulting from the Santa Clara County Assessor's Office (Assessor's Office) cycle audits of business property tax returns are not credited to the Agency. According to the Assessor's Office, these audits typically recover a significant amount of money. Because the Agency receives tax increments based upon 100 percent of the tax levy in redevelopment project areas, recoveries of business property taxes in redevelopment areas should be allocated in full to the Agency. The Assessor's Office was not able to identify how much revenue has been recovered in redevelopment project areas as a result of its cycle audits.

– The results of property tax assessment appeals are not charged to the Agency. Property tax assessment appeals are a growing problem County-wide. As was the case with cycle audits, the Assessor's Office was not able to identify the amount of revenue that has been refunded to property owners in redevelopment areas.

Our review also revealed the following two methodological problems with the County's calculation of property tax increments:

– The County used the wrong tax rate for unsecured property when calculating tax increments due to the Agency. Specifically, the tax rate on unsecured property is the previous year's rate for secured property.

However, when calculating its tax increment estimate, the County has apparently been applying the current year's instead of the previous year's secured property tax rates against unsecured assessed valuations. This can result in the Agency receiving less revenue than it should because secured property tax rates are generally dropping as bonds and other obligations that were grandfathered in under Proposition 13 are paid off. We estimate that the County's use of the current year's secured property tax could have cost the Agency approximately $260,000 from 1989-90 through 1991-92.

– The County has not reduced the base year assessed valuation in redevelopment areas to account for the withdrawal from the tax rolls of publicly owned properties. According to the Assessor's Office, when a public agency purchases a property, the base year value of that property (its value at the time the redevelopment project area was formed) should be removed from base year valuation at the same time as the property is taken off the tax rolls. The failure of the County to reduce base year tax rolls for public agency property purchases results in the Agency receiving less in tax increment revenues than it should. Again, the Assessor's Office was unable to determine how much revenue the Agency lost as a result of the County understatement of tax increments in redevelopment areas.

It should be noted that the above two subjects are part of a pending lawsuit between the City, the Agency, and the County. Resolution of these items may have an impact on future Agency revenues.

Click On The Appropriate Box To View Item

Administrator's Response

Appendix A

Appendix B

Appendix C

Appendix D

Appendix E